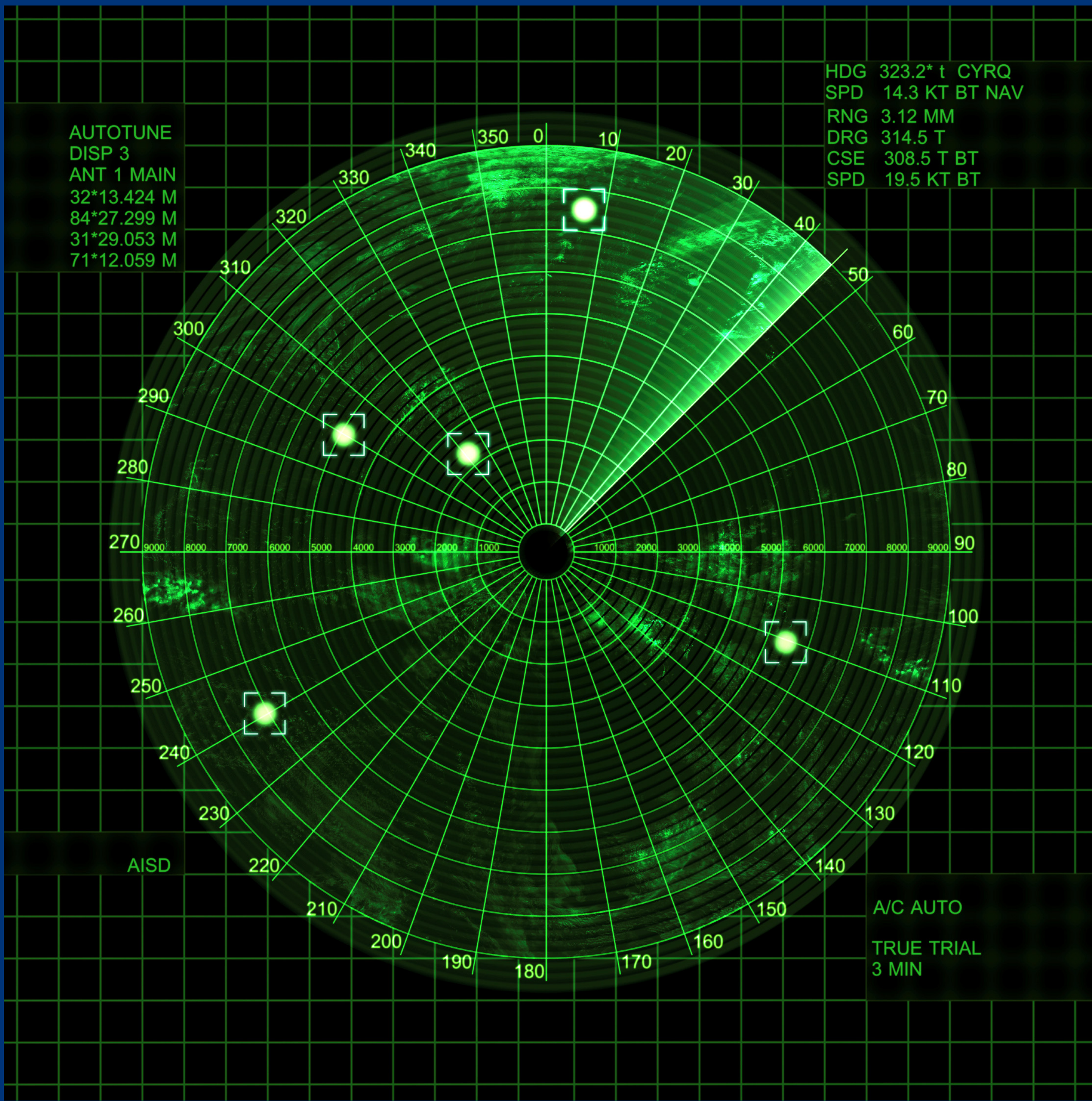
Sensors for investors

Aerospace & defence sector

September 2010



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Published by Edison Investment Research

With thanks to Anish Majmudar for his contribution to background research.

UK aerospace & defence

Sensors for investors

The Strategic Defence & Security Review (SDSR) is being undertaken in double-quick time to coincide with the October comprehensive spending review, and we anticipate this will provide investors with both opportunities and threats in the UK aerospace & defence (A&D) sector. With volatility expected to remain high, we favour those companies with broad exposure to geographical markets or across civil and defence customers. In particular, we highlight BAE Systems, Rolls-Royce, Babcock, Chemring and Avon Rubber.

27 September 2010

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COMPANIES IN THIS REPORT

Avon Rubber*
Babcock
BAE Systems
Chemring
Cobham
Cohort
Hampson
Meggitt
QinetiQ
Rolls-Royce
Ultra Electronics
Umeco

**Edison client*

UK market set for tough cuts

We have identified four areas that could face cuts: 1) equipment; 2) MoD central costs; 3) MoD estate; and 4) armed forces size and shape. While these will be reviewed as part of the SDSR, we remain concerned about how strategic the review can possibly be at a time of demands for cuts across government.

But...the UK is not where it's at

However, in our view it is misleading to concentrate on what is happening solely in the UK, as the industry is one of the most global in its outlook. With only 20% of revenues derived from the home market and many companies having a considerably greater presence in the largest market, the US, we have also sought to provide an insight into the global threats and opportunities.

Valuations skewed by defence fears

We identify four themes in the sector at the moment: 1) Sure and steady – RR, ULE; 2) The defence cuts are coming – BAE, BAB, CHG, AVON; 3) Issues and restructuring – QQ, CHRT, HAMP, COB; and 4) Civil back on its feet – UMC, MGGT. While this simple approach may appeal to many, we feel there are opportunities for those willing to see through the current noise and uncertainty.

Favoured picks – opportunities for the brave

We favour those companies with broad geographical markets or cross civil/ defence exposure. We highlight BAE Systems, Rolls-Royce, Babcock, Chemring and Avon Rubber as our favoured picks. While there may be short-term volatility, we believe these stocks provide good long-term value.

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Context

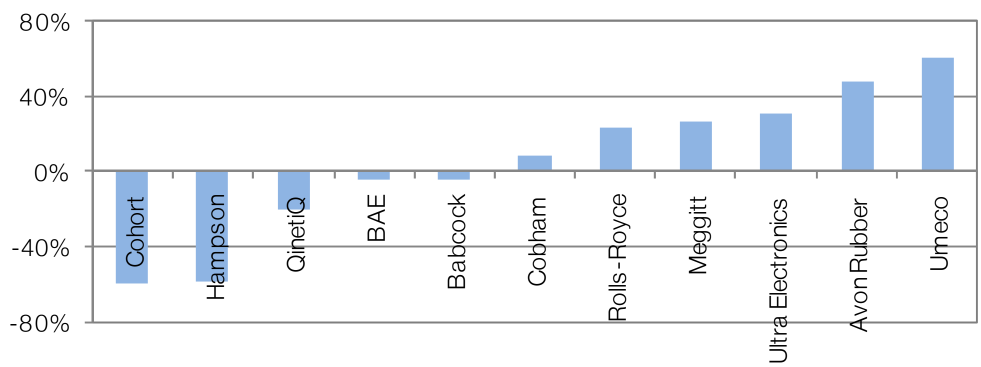
The UK aerospace & defence industry is made up of a wide range of companies operating at all levels of the supply chain, from prime contractors through to Tier 3 component suppliers.

- 2009 proved a difficult year for the global A&D industry, with the worst civil aviation downturn in recent history causing aftermarket revenues to weaken and OE demand to slow. Due to the large backlogs built up at Airbus and Boeing, production rates remained level and, with defence budgets relatively stable, many companies were able to maintain profits through swift cost management actions.
- 2010 has so far seen a modest recovery in civil markets, with air traffic back on the increase and OE production rates set to rise again from 2011. The focus now has turned to the impact of deficit reductions on government spending and the outlook for the global economy on civil aerospace.
- Longer term, we feel that globalisation will continue to play its part with emerging economies dominating demand for civil aircraft and, with western defence markets remaining under pressure, an increasing focus on international defence opportunities. This in turn is leading to the emergence of new competitors in the industry and is driving the strategy of many companies.

Share price performance

The past 12 months have seen a wide range of UK share price performances, echoing wider market issues. This has seen the civil-focused aerospace stocks, in particular, recovering with the previous forecasts of a rapid decline in production proving false. Defence plays have predominantly been rather subdued, with growth slowing and concerns increasing around global budgets.

Exhibit 1: UK A&D companies' 12-month share price performance



Source: Edison Investment Research

At the extremes, we highlight the following points:

- Cohort, Hampson and QinetiQ all gave profit warnings in the period, mainly as a result of order delays.
- Umeco recovered from an all-time low following a significant decline in late 2008 driven by concerns over debt levels and market outlook.

Investment themes – short-term driver, SDSR

With a total spend on UK Defence of c £41bn in 2009, there are several areas that could come under greater scrutiny in the forthcoming SDSR and budget rounds. Our view is that the armed forces are overstretched for current operations and so any cuts would require a reduction in the number of tasks the armed forces were ready to undertake. Below we list the areas of spend we see as most likely to face cuts:

- Defence Equipment & Support (DE&S), accounting for £16.8bn of total spend.
- The personnel cost of the three services, £11.6bn.
- MoD administration costs of c £2.1bn.
- Defence Estates, accounting for £3.6bn.
- Science, Innovation, Technology – £500m, having declined steadily over the past decade.

Given the challenge of reducing spending by c 25-40%, this would imply savings of between £10bn and £16bn. As can clearly be seen this will be a challenging task.

Who is most exposed – are there any winners?

With the most likely scenario a combination of force reduction, equipment programme slippage or cancellation and a further outsourcing of the defence estate, we believe there are few companies in the industry that will not be touched in some form or another. Different participants will be affected to differing degrees both in UK terms and across the wider businesses:

Exhibit 2: Areas of potential cuts and companies impacted

	Companies affected	Potential outcome	Mitigation for industry?
Defence equipment & support	BAE, Babcock, Rolls-Royce, Cobham, Ultra Electronics	Reduction or cancellation of new build platforms.	Increased upgrade of older platforms to fill capability gap.
Force personnel numbers	BAE, Babcock, Cohort, Chemring	Reduction in force numbers and structure leading to lower levels of equipment usage.	Increased need for industry support behind the front-line.
MoD administration	BAE, Babcock, Cohort, QinetiQ	Reduction in MoD central staff.	Opportunity for industry to particpate in areas previosuly deemed out-of-bounds.
Defence estates	BAE, Babcock, QinetiQ	Reduction in number of MoD bases and facilities.	Further opportunity for outsourcing to provide cost-savings.
Science, innovation, technology	QinetiQ, Cohort	Further reduction in R&D budget.	Increasing reliance on non-MoD personnel to carry out research.

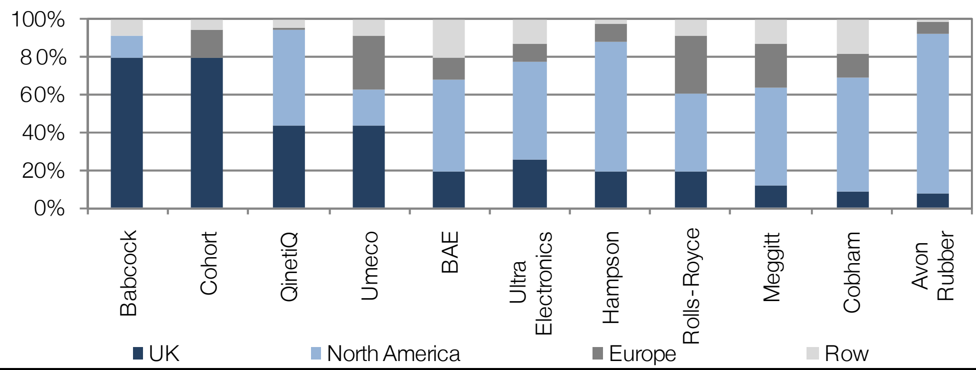
Source: Edison Investment Research

As can be seen, there are several players that will likely see some form of cut in business that they undertake. The main reason for this is simply the structure of the industry with the dominance of one or two large companies as there has been insufficient indigenous work to maintain full competition. This also means that while cuts may be sought, industry will need to be heavily involved to fully implement them.

Placing it in context – US dominates, civil recovering

Despite the outlook in the UK appearing bleak for many in the industry, we would highlight that the UK government only accounts for c 20% of UK industry's revenues. We feel that many investors are overlooking this fact and that even if deep cuts were forced through, the industry in general will be able to maintain its position as a leading exporter. Indeed, many in the industry have built a significant presence outside the country, which highlights the reduced reliance on the home market. The US market is the single most important market with a defence budget accounting for half the global expenditure at some $708bn; we feel that the trends in this market that will have the greatest bearing on the industry's future as a whole.

Exhibit 3: Company revenues by destination

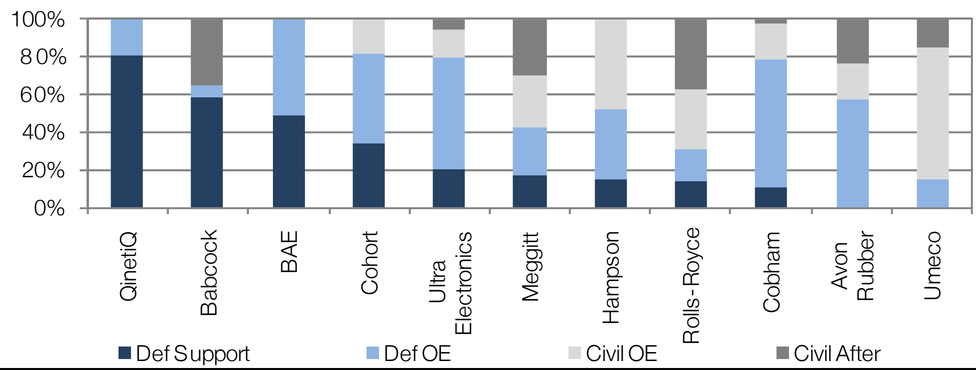


Source: Edison Investment Research estimates

As can be seen in Exhibit 3, apart from Babcock and Cohort, the majority of companies have revenue streams that are largely outside the UK. Those we highlight with significant North American exposure include BAE Systems, Cobham, Ultra Electronics, Hampson, Meggitt and Avon Rubber, all of which have over 50% of revenues derived from this region.

In addition, with civil aerospace accounting for c 50% of industry revenues, the recovery in this market will provide upside for those companies over the coming years.

Exhibit 4: Defence/civil sales split by company



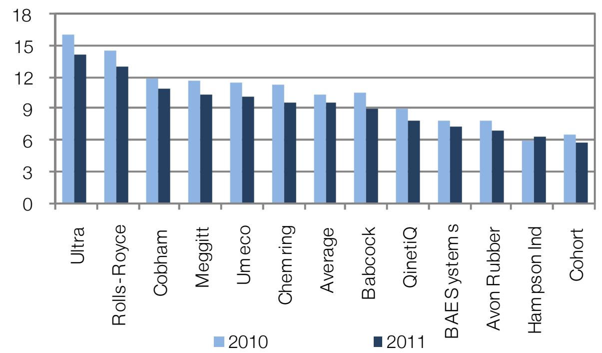
Source: Edison Investment Research estimates

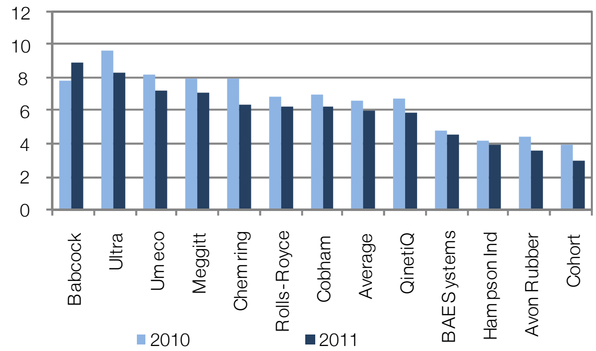
As can be seen in Exhibit 4, those most exposed to the commercial market are Umeco, Rolls-Royce, Meggitt and Hampson.

Investment themes – longer-term opportunities

With the noise surrounding defence ever increasing ahead of the SDSR, and with a recovery in the civil market in its early stages, we feel there are several themes to be played.

Exhibit 5: UK company P/E and EV/EBITDA ratings





Source: Edison Investment Research

We feel they can be broadly categorised into four main areas, reflected, in the current uncertain environment, in a wide range of company share valuations (see Exhibit 5 above).

1) Sure & steady - Ultra Electronics and Rolls-Royce

This category is highly rated. The companies have demonstrated resilience throughout the recession and are anticipated to continue to deliver even against the current backdrop. We believe that both these companies deserve their premium rating and should provide good long-term upgrades.

2) Exposed to defence – BAE Systems, Babcock, Avon Rubber

Despite having demonstrated an ability to weather any slowdown in markets in the past, these companies appear to be over-discounted for the cuts that are coming. We feel that the combination of exposure to the US market (BAE and Avon) and the opportunity for defence outsourcing (Babcock and BAE) should provide a greater element of resilience than appears to be credited. We believe that these companies provide good long-term value but are likely to underperform in the short term.

3) Issues & restructuring – Cohort, QinetiQ, Hampson, Cobham

With varying issues, these companies are trading at lower-than-normal ratings. We feel that the concerns surrounding Cohort and QinetiQ in terms of long-term market outlook and the need to restructure are warranted. If Hampson can demonstrate that recent orders can be delivered on time to remain within covenants and that further orders are forthcoming, then a re-rating could well occur. Likewise, we feel that once the benefits of Cobham's restructuring plan are known more fully, its previous premium to the sector could well be restored.

4) The civil sector rebound – Umeco, Meggitt

From lows around 18 months ago, when concerns surrounding the civil market coincided with concerns surrounding debt levels, both Meggitt and Umeco have rebounded strongly. The key question in our view now is how much further these can go without earnings upgrades. We believe that once the civil recovery gets fully underway, these will be among the first companies in the sector to benefit.

Sensitivities

The UK aerospace & defence sector is subject to a number of sensitivities that can impact its performance:

- **Macroeconomic outlook.** Civil aerospace build rates and aftermarket revenues are ultimately driven by the demand for air travel, which is linked to economic growth. As a result any shocks to the global economy, as witnessed following the financial crisis, can have a significant impact on the industrial outlook.
- **Politics and government budgets.** Defence markets around the globe are driven by the political stance of governments. Any major change in policy would have an impact on the industry. However, given current instability and the global threat environment, we do not anticipate any major shift in approach in the short term.
- **Currency.** With the global nature of the industry, UK companies are often affected by changes in currency, in particular the impact of the US dollar rate. The industry has a long history of dealing with the impact of currency variations and is therefore adept at managing transaction exposure through global operations. Translation impact will remain a feature.

Fair value assessment

The following table highlights our assessment of fair value.

Exhibit 6: SOTP fair value table

	Market Cap (£m)	Share Price (p)	SOTP Fair Value (p)	% Upside / (Downside)	Comment
FTSE 100					
BAE Systems	13,390	330	435	32%	Overly discounted for Defence cuts
Cobham	2,691	235	265	13%	Re-rating once restructuring benefits known
Rolls-Royce	10,768	577	635	10%	Good long-term growth
FTSE Mid/Small Cap					
Avon Rubber	44	143	190	33%	Expanding products and markets
Babcock	2,035	548	690	26%	Current discount for defence cuts / opp for synergies
Chemring	970	2,939	3,655	24%	Above average growth to remain
Cohort	28	65	110	71%	If control demonstrated, upside potential
Hampson Ind	51	31	50	60%	If covenents maintained, significant upside potential
Meggitt	1,950	294	295	0%	Awaiting upturn in civil, forecast upgrades will drive
QinetiQ	742	109	95	-13%	Structural issues in declining spend environment
Ultra	1,186	1,655	1,640	-1%	Appears expensive, but forecasts do not include acquisitons
Umeco	212	437	450	3%	Awaiting upturn in civil, forecast upgrades will drive price

Source: Edison Investment Research

We favour those companies with a broad exposure to either geographical markets or across civil/ defence markets.

- We highlight BAE Systems, Rolls-Royce, Babcock, Chemring and Avon Rubber as our favoured picks.
- The small-cap arena offers higher risk, but potentially higher reward investments through Cohort and Hampson where company specific issues dominate.
- We remain concerned with the combination of a declining market outlook and the scale of restructuring required at QinetiQ.

Market background

In this section we analyse the history, outlook and issues surrounding the US, UK and RoW defence markets, as well as the civil aerospace OEM and aftermarket.

Defence

Given the continued military activity across the globe, including the conflict in Afghanistan, defence remains an important facet of government spending. However, the imperative for western governments in particular to cut their budget deficits is due to put stress into the system and remove the view of defence as a safe haven for all involved.

- US defence – The largest budget in the world at c $700bn pa. We believe that despite budgetary pressures, defence spending in the US is set to remain healthy, albeit with real growth slowing to a modest 1% pa from 2011 onwards.
- UK defence – There will undoubtedly be cuts over the longer term in our view, although we believe that such changes will have to be made in partnership with industry. While equipment choices will have to be made, these will be guided by the SDSR process and an understanding of long-term priorities. We believe the difficulty will be achieving an appropriate balance between the needs of today versus those of potential future conflicts and, as a result, we anticipate flexibility to be key.
- RoW – While there will be cuts in Europe, there are still areas of the world in which defence spending growth remains high and there are prospects for significant new programmes.

As a result, we believe there is an increasing trend for companies to access export markets and reduce dependence on home markets, something to which UK industry has become very adept.

Civil aerospace

With economic growth signals returning and airlines seeing an uptick in passenger demand to pre-recession levels, we view the outlook for the civil aerospace market as an improving picture.

- Civil OEM – With demand returning, new build orders are on an upward trend and production rates are set to increase steadily over the coming years, as higher volume narrow-body deliveries step up and new aircraft start to ramp-up production.
- Civil Aftermarket – While airlines are cautious about reinstating capacity too quickly, passenger demand and load factors are on the increase, providing early indicators of the need to add further capacity at some stage soon. It is this capacity growth that will drive the industry’s aftermarket revenues.

Longer term, new entrants in Russia, China and Japan will drive technological development and investment over the next decade, which will feed through to the wider civil supply chain.

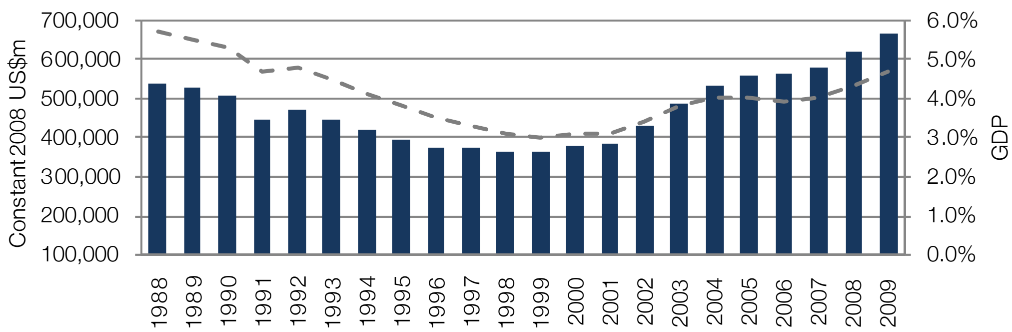
US Defence – stable in the near to medium term

The US Defence budget remains the largest in the world, accounting for just under 50% of global defence spending, with an FY11 budget request of $708bn highlighting the fact that this position of superiority is unlikely to change in the short term. Despite the current economic climate, we view the outlook for spending in the US as stable, with modest but slowing growth over the coming years of the order of 2-3% pa, or 1% in real terms.

Budget history – not a peak despite ongoing conflicts

Although the modern US defence budget appears to be at an all-time high in absolute terms, we highlight the fact that, at c 4-5% of GDP, it is in fact relatively low in historical terms. The amount spent on defence at the height of the Cold War reached closer to 6% and at the peak of the Vietnam War, it was 8.9%.

Exhibit 7: Long-term US defence budget and % GDP



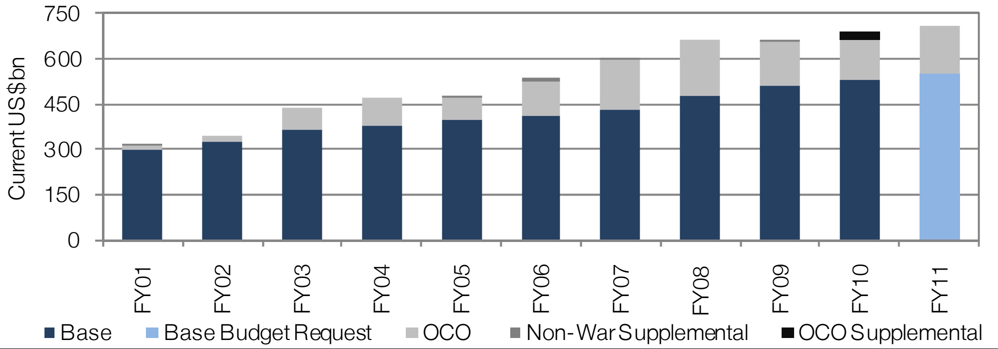
Source: SIPRI Military Expenditure Database and Edison Investment Research

As Exhibit 7 shows, there was a clear peace dividend following the collapse of the former Soviet Union and the end of the Cold War. This saw the defence budget cut and gave rise to the now famous "last supper" speech to the US defence industry by the then Defense Secretary William Perry, which spurred consolidation and the creation of fewer more powerful players that are evident today. This decline over the course of the 1990s was reversed significantly post 9-11 when defence spending was kick-started yet again and policy shifted rapidly to counter-act the new perceived threat of global terrorism.

Recent history – period of increasing spend

The past decade has seen the budget rise steadily year-on-year, driven by the global war on terror and an increased realisation that the US was not invulnerable even on home soil. This increase has been rapid and continued with a CAGR of some 8% pa giving rise to an environment that has seen the defence industry enjoy a boon in sales and rapid development of a number of new programmes driven by operational requirements and supported by the large overseas contingency operations (OCO) spend. Even stripping this out, the base budget has risen at a rate of some 6% pa over the past decade.

Exhibit 8: US defence budget – recent trends



Source: FY11 presidential budget request

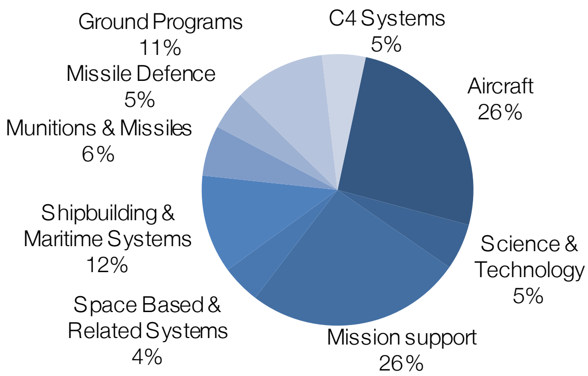
Budget breakdown FY11 – short-term little change

The FY11 Presidential Budget Request submitted in February 2010 called for a US Defence Budget of some $708bn, split between a base level of $549bn ($18bn higher than the 2010 enacted amount of $531bn) and $159bn related to overseas contingency operations (OCO). This equates to a 3.4% increase in the base budget, or 1.8% in real terms.

FY11 budget – what can industry access?

While the overall budget remains significant, in reality industry cannot access the whole $708bn due to expenditure on military personnel, operations and housing etc. Once spending on these areas is taken into consideration, the largest segments available to industry are in procurement and research, development, test and evaluation (RDT&E). In FY11, these represent a combined total of $215bn across baseline ($189bn) and OCO ($25bn) budgets.

Exhibit 9: Areas of spend – US DoD Modernisation, Base & OCO (total US$214.6bn)



Source: FY11 Presidential budget request

Exhibit 9 above shows the breakdown of the programme acquisition requests across the DoD by category. Here we summarise the major elements that are most relevant to UK participants:

- **Aircraft.** Funding increased by 3% to $55.4bn. This continues funding for concurrent development and production of the **F-35** aircraft producing 7 Carrier Variants (CV) for the US Navy, 13 Short Take-Off and Vertical Landing (STOVL) for the Marine Corps and 22 Conventional Take-Off and Landing (CTOL) variants for the USAF. In total the FY11 budget calls for $11.4bn for this programme alone. Other programmes relevant to UK participants include the **V-22 Osprey**, with a budget of $2.8bn and RDT&E funding of

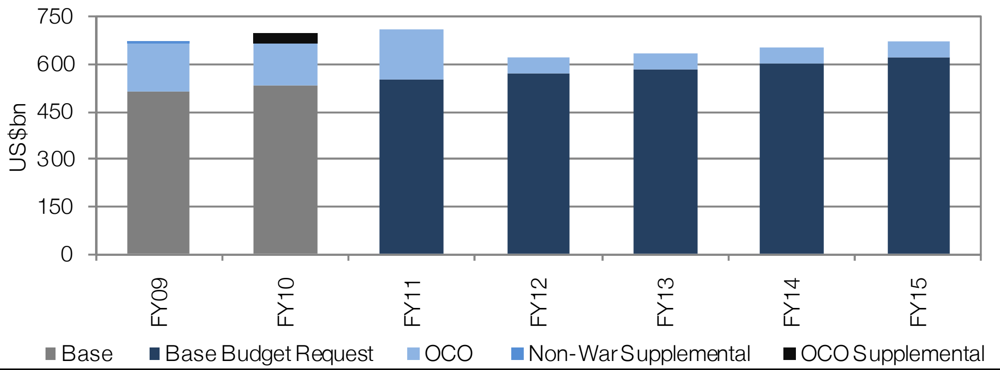
$864m for the KC-X Tanker replacement programme, the competition for which has now re-opened.

- Ground programmes. Funding decreased by 11% to $23.3bn as a result of the wind down of the MRAP procurement cycle and the move to Afghanistan requiring different vehicle types. FY11 procurement includes $12.1bn for equipment support and future developments will centre on modernisation activity, of particular interest is the Joint Light Tactical Vehicle (JLTV) to replace the ageing HMMWV. Funding is requested to take the technology demonstrator programme through to a milestone B decision in Q411.
- Shipbuilding and maritime. Funding increased by 12% to $25.1bn. This funding goes towards supporting the US Navy's target of a 313 ship fleet, with the major spend directed towards surface combatants with approximately half the funding at $12.3bn.
- C4 systems. Funding increased by 6% to $11.1bn. $9.1bn of this relates to theatre combat control and communications and services. The major programmes within the budget include: the Joint Tactical Radio System (JTRS) with funding of $1.1bn; Brigade Combat Team (BCT) Modernisation with $3.2bn; and Warfighter Information Network – Tactical (WIN-T) with funding of $630m. We believe that C4 Systems will continue to be a growing area of investment and is one in which many UK companies are well exposed.

Budget outlook – economic and political issues

Given the current economic climate, the US Defence Budget is undoubtedly under increasing scrutiny and pressure. However, taking the FY11 Presidential Budget Request we can see that the initial budgetary forecasts out to FY15 have a baseline nominal growth of some 3% pa with real growth of c 1%. Also included are placeholder funds of $50bn pa for OCO funds, which will invariably get topped up once the actual outturn requirements for these activities become known.

Exhibit 10: US Defence Budget – Future profile



Source: FY11 Presidential budget request

The key work that has gone into influencing this budget was the 2010 Quadrennial Defense Review (QDR). This sets out the strategy and priorities for the presidential term and forms the basis around which future planning occurs.

Quadrennial Defense Review – guiding the future

US Secretary of Defense, Robert Gates, announced the QDR alongside the FY11 Presidential Budget Request in February 2010. There were a number of key themes that have altered priorities and the manner in which the DoD does business, supported by FY11 funding. These included:

Taking care of people. The QDR identified a list of key priorities in ensuring that the US DoD maintained the care of its service personnel. These included the sustainment of the all-voluntary military; care for the wounded, ill and injured; enhancement of military health system and family support programmes; and the building and sustainment of facilities. Each of these elements received additional funding in the FY11 baseline budget and are contained in areas of spend outside the traditional reach of industry.

Rebalancing the military. The focus is on providing the correct balance between prevailing in current conflicts versus preparing for future contingencies; institutionalising capabilities such as counterinsurgency and foreign military assistance versus conventional US strategic and technological edge over other militaries; and retaining desired cultural traits versus shedding those that act as inhibitors to progress. Within this balancing act, the following priorities emerged:

- Enhancing capabilities for current conflicts. The FY11 budget strives to enhance the capabilities across a broad spectrum of current needs with particular emphasis on rotary wing aircraft, intelligence surveillance and reconnaissance (ISR), electronic warfare (EW), an increase in funding for special operations forces, countering weapons of mass destruction, improving homeland security responses and the creation of a US Cyber Command (USCYBERCOM) to reflect the increasing importance of cyber security.
- Enhancing capabilities for future conflicts. The FY11 budget also makes substantial investment in future capability. This encompasses support for the JSF (Joint Strike Fighter) with a restructured programme to stabilise schedule and cost, and the annual proposal for the cancellation of the alternate engine, but it remains to be seen whether it is reinstated yet again in later rounds. Other areas of note include the funding for development of the KC-X new tanker aircraft, a realistic, executable shipbuilding plan throughout the FY11-15 timeframe and the modernisation of ground forces through the Brigade Combat Team (BCT) following last year's restructuring of the Future Combat System (FCS) programme.
- Advancing a new missile defence approach. The priorities laid out in the Ballistic Missile Defense Review in January 2010 highlighted the key themes supported by the FY11 budget: defending the Homeland against limited ballistic missile attacks; defending against regional missile threats to US forces, allies and partners; rigorously testing new capabilities before they are deployed; developing new capabilities that are fiscally sustainable; fielding missile defences that are adaptable to future threats; and expanding international efforts. To support these themes, funding has been set at $9.9bn.
- Strengthening the reserve components of the force. The QDR focused on using the National Guard and Reserve as a seamless element of the total force. This has seen a shift of emphasis of to an operational reserve rather than a force of last resort. The FY11 budget request supports these initiatives and the department's ready reserve totalling c

1.1 million members, or about 43% of the total military end strength at a cost of c 9% of the base budget.

Reforming what and how the DoD buys. Acquisition reform is a major development with the current administration and this has seen significant changes to both acquisition priorities and an intention to change the structure of the DoD acquisition process. The main elements include:

- Change what the DoD buys. The aim has been to end troubled programmes and to achieve a better balance of current and future capability as described above. This resulted in termination of a number of programmes in the FY10 budget request, which has been followed up by further terminations put forward in the FY11 request. These include: C-17 procurement; JSF alternate engine; large cruiser CG(X), Navy intelligence aircraft EP(x); and third generation infrared surveillance (3GIRS). In addition two further programmes, the Defense Integrated Military Human Resources System and Net Enabled Command and Control, have been cancelled due to poor performance. In essence the goal of the future US acquisition programme is to develop a portfolio of capabilities to respond to a range of threats with the QDR highlighting what that mix should look like.
- Changing how the DoD buys. Equally important in our view for industry is the change in how the DoD is approaching procurement. This reform centres on people, process, cost estimation and execution. The DoD acquisition workforce is slated to increase by 20,000 positions in 2015 from c 127,000 in 2010, including insourcing of 10,000 positions. The process element will be addressed predominantly at the front-end of the acquisition cycle with a new Development Decision Milestone and ongoing independent reviews before progress to the final phase of development. Cost estimation will be addressed through the new Cost Assessment and Program Evaluation (CAPE) organisation. In our view, one of the most important elements is the steps around execution, with contracting types being implemented aligned with the programme type. Configuration Steering Boards will also address the issue of requirement creep and the contracting structure will be designed to align profitability with performance. In total, these steps will alter the traditional US cost-plus approach and tighten up multi-year contracts. We have already seen the impact of this on the contracting environment, with delays in contract signatures in H110.

Supporting troops in the field. The FY11 budget request includes $159.3bn for overseas contingency operations (OCO) to support Operation Enduring Freedom (OEF), mostly in Afghanistan, and Operation Iraqi Freedom, mostly in Iraq. As the US winds down its presence in Iraq and surges in Afghanistan, many issues remain similar, but other priorities have shifted. The breakdown of the OCO budget is shown in Exhibit 11.

Exhibit 11: US overseas contingency operations budget (US$bn)

	Enacted	FY10 supplemental	Total	FY11 request
Operations	74.5	19.0	93.5	89.4
Force Protection	15.2	3.3	18.5	12.0
IED Defeat	1.8	0.4	2.2	3.3
Military Intelligence Program (Incl ISR)	4.6	1.3	5.9	7.0
Iraq Security Forces	0.0	1.0	1.0	2.0
Afghanistan Security Forces	6.6	2.6	9.2	11.6
Coalition Support	1.9	0.0	1.9	2.0
Commander's Emergency Response Program	1.2	0.0	1.2	1.3
Military Construction	1.4	0.5	1.9	1.2
Reconstitution / Reset	17.0	1.7	18.7	21.3
Army End Strength	1.0	0.0	1.0	2.1
Navy End Strength	0.4	0.0	0.4	0.5
Baseline Fuel	0.0	2.0	2.0	0.0
Non-DoD Classified	4.1	1.2	5.3	5.6
Total operations	129.6	33.0	162.6	159.3

Source: FY11 Presidential budget request

We would highlight four areas of interest in these figures: 1) The reduction in force protection relates to a shift in spend on Mine Resistant Ambush protected (MRAP) vehicles as terrain conditions differ between the two theatres. 2) Spend on IED Defeat continues to grow rapidly as this is the largest individual threat to troops in Afghanistan. 3) Military intelligence gathering capabilities have seen a step-up in funding highlighting the importance of this area in modern warfare. 4) Reconstitution and reset continues apace, supporting spend on existing in-service platforms.

We have also seen a move in OCO funding to becoming a true war-related budget with those programmes that were previously using supplemental funds to boost base budget shortfalls removed. As a result, we believe that there will be continued shift of certain elements from OCO into the base budget, where funding would continue even if operations ceased immediately. This introduces further pressure on baseline programmes where such practices previously existed.

Conclusion – slowing growth, but still a good place for UK industry

Overall, we believe that despite the current economic pressures and the recent assertion by the US Secretary of Defense, Robert Gates, that “the culture of endless money...must be replaced with a culture of savings and restraint”, defence spending in the US is set to remain healthy with real growth slowing to a modest 1% pa from 2011 onwards. Indeed, Gates’s focus was on the overhead structure and not directed at weapons spend directly.

In addition, however, we highlight that, with the exception of BAE Systems as the fourth-largest defence supplier to the US DOD, no other UK company has a position large enough to be concerned with the macro-level changes in budget to within a few percentage points. As a result, we remain convinced of our view that the US is an attractive place to do business and we anticipate UK companies to continue their expansion and focus in the market.

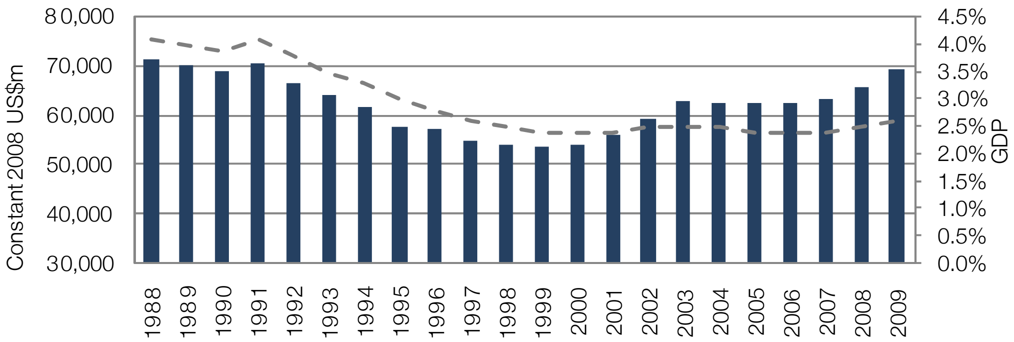
UK Defence – seeing the wood for the trees

Turning to the UK industry's indigenous market we see a very different story with defence spending not only set to come under intense scrutiny, but a real downward pressure on the budget. We believe that, as a result, we are likely to see many changes to both programmes and the very structure of the UK military. With Defence having been spared initial rounds of cuts in the emergency budget we view the forthcoming (October 2010) Strategic Defence & Security Review (SDSR) as instrumental in defining what the UK military's role is and therefore what structure and equipment is required to carry out that role. One thing we believe is that if cuts are to be made as indicated, the current planning assumptions for operations can no longer be sustained.

Budget history – still around lows in GDP terms

The UK MoD defence budget saw similar trends to that of the US following the collapse of the Soviet Union with a decline in the budget and a rapid decrease in investment until the end of 2000. While expenditure increased rapidly in the US, the UK did not undergo such a surge, with expenditure only recently touching the levels in real terms seen in the late 1980s and early 1990s. Indeed when viewed as a proportion of GDP, the 2009 figure of 2.6% sits not much higher than the lows encountered at the turn of the century of 2.4%.

Exhibit 12: Long-term UK MoD defence budget and % GDP



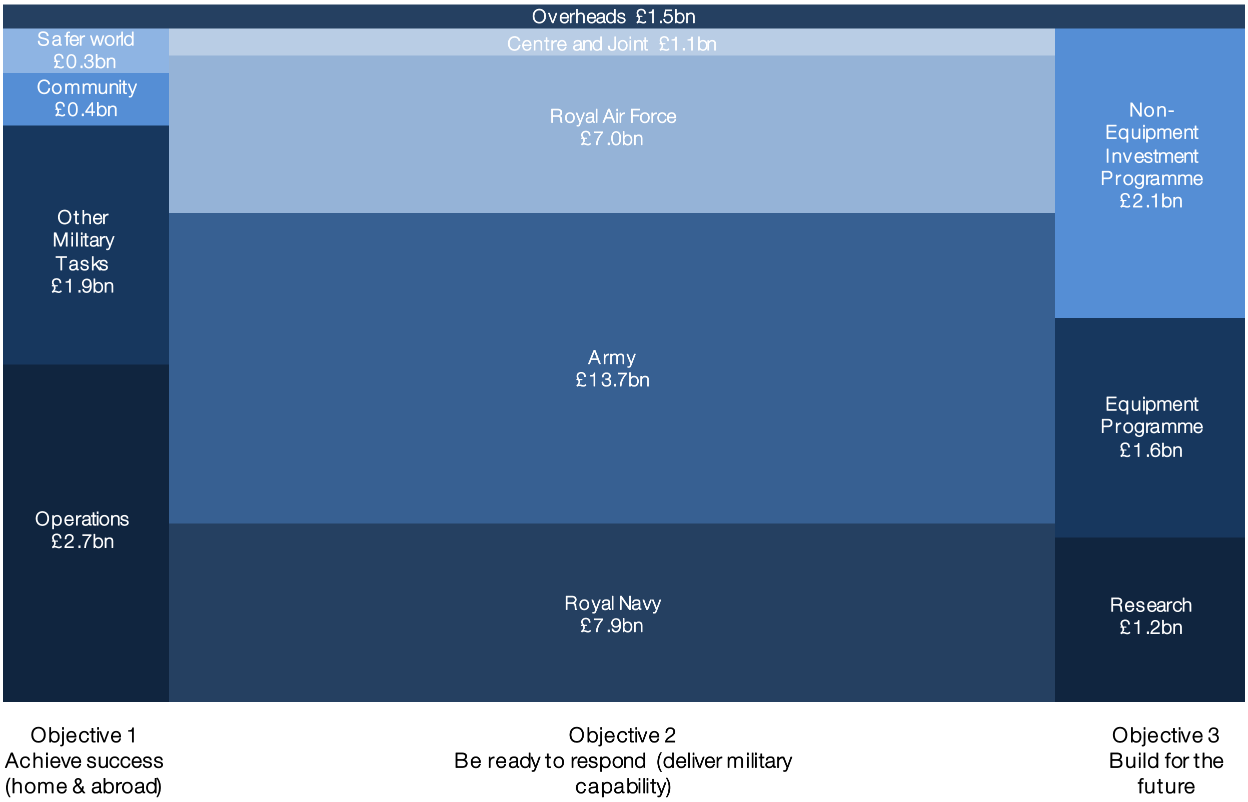
Source: SIPRI Military Expenditure Database and Edison Investment Research

In terms of the recent trends, we have seen the UK MOD budget rise in absolute terms but fall in real terms during three of the last 10 years, as was highlighted by the former Prime Minister Gordon Brown following his clarification on defence spending after his appearance at the Iraq Inquiry on 5 March.

Budget breakdown – complex and opaque

One of the difficulties in addressing the underlying UK budget figures is the level of detail of the available information. We have used the MoD annual report and accounts to construct various views of the budget to provide some clarity in how it is spent. As a result we can identify which areas may come under scrutiny in the forthcoming SDSR and Comprehensive Spending Review (CSR).

Exhibit 13: Areas of spend by objective



Source: UK MoD Annual Report & Accounts 2009-10

Exhibit 13 shows the three objectives of the MoD to support its main aim to deliver security for the people of the UK and Overseas Territories by defending them, including against terrorism, and to act as a force for good by strengthening international peace and stability. These are to:

1) Achieve success in the military tasks undertaken, at home and abroad. This includes current deployed operations, such as Afghanistan, and tasks in the UK, such as countering terrorism, maintaining territorial integrity and search and rescue.

2) Be ready to respond to the tasks that might arise. This is essentially the cost of delivering the military capabilities necessary to address a portfolio of potential military tasks. This comprises the direct operating costs of the front line units and the attributed costs of logistic and personnel support in each force element. It also contains a share of head office costs and centrally provided services.

3) Build for the future. Research includes both direct fundamental research as budgeted for by the science, innovation, technology budget and also research carried out across over budget holders. The Equipment Programme contains the cost associated with specifying requirements for a procurement of fighting equipment and other assets and the non-equipment element relates to the administration and programme costs of specifying and delivering investment in defence estates.

As can be seen, the largest element of spend occurs within objective 2, which is essentially the ongoing running cost of the three services and their equipment. Taking each service in turn we can analyse the areas in which spend is greatest.

Exhibit 14: Objective 2 spend across the three main services - £m

Royal Navy	2009/10	Army	2009/10	Royal Air Force	2009/10
Aircraft carriers	349	Field units	10,795	Combat a/c	1,997
Frigates, Destroyers & smaller warships	1,613	Other units	2,890	ISTAR a/c	1,584
Amphibious, support & other ships	1,114			Tankers, transport and comms a/c	1,170
Naval aircraft	1,748			Future capability	800
Submarines	2,524			Other a/c and RAF units	1,450
Royal Marines	598				
Total RN	7,946	Total Army	13,685	Total RAF	7,001

Source: UK MoD Annual Report & Accounts 2009-10

Royal Navy

As can be seen the most significant spend within the Navy centres around the submarine fleet with a cost of over £2.5bn pa. This includes the operating costs of submarines, nuclear weapons systems and logistics support of nuclear propulsion, including nuclear decommissioning. The naval aircraft element includes the Sea King, Lynx and Merlin helicopters deployed in anti-submarine, airborne early warning, Royal Marine Support and reconnaissance and attack roles.

Army

Given the current focus on land-based operations over the past decade, it comes as no surprise that spend on the Army is the highest of the three services, approaching some £13.7bn in 2009/10. This is split between the field units, which include the 1 (UK) Armoured Division, 3 (UK) Division, Joint Helicopter Command and Theatre troops and the other units, including regional divisions, Land Support and training.

Royal Air Force (RAF)

The RAF currently has spend approaching £2bn pa on combat aircraft, which is spread across a range of platforms including Tornado GR4, Harrier, Typhoon and Tornado F3s deployed in strike / attack and air defence roles. Interestingly, the Future Capability element includes the joint Test & Evaluation Group, development and use of geographic information as well as the Nimrod MRA4 aircraft.

Centre grouping

In addition to the three services, there is also an additional spend on the centre, which includes joint and multinational operations, intelligence support and Special Forces at a total cost of some £1.1bn.

Alternative view - Request for Resources

The defence budget is also visible via the Request for Resources as shown in Exhibit 15, which identifies the true Top Level Budget Holders (TLBs) that are appropriated the funds.

Exhibit 15: Areas of spend by Request for Resource and Top Level Budget holder

Source: UK MoD Annual Report & Accounts 2009-10

This provides a view of where the areas of spend that could be vulnerable in the forthcoming budgetary squeeze. A number of points become clear:

- Defence Equipment & Support (DE&S) accounts for c 41% of total spend.
- The personnel cost of the three services account for 28% of the total.
- MoD administration costs are approximately the same as that of the Royal Navy.
- Defence Estates account for nearly 10% of MoD costs.
- Science, Innovation, Technology – the future research and development spend is less than £500m and has declined steadily over the past decade.

This provides an outline of where future defence spending cuts will be targeted and provides some context to identify what the potential impact in certain areas of the budget could be.

Strategic Defence & Security Review – setting out the priorities

The forthcoming Strategic Defence & Security Review (SDSR) is due to set the scene within which the future spending priorities of the MoD will be framed. In our view the interesting question here is to what extent the review will be threat driven versus budget driven. Given the timing of the review in the autumn, coinciding with the comprehensive spending review, we feel that despite best efforts for requirements to be threat based, it may well be difficult for spending concerns not to have a major influence on thinking. The Secretary of State for Defence, Liam Fox, has publically stated that it should be a step-change in strategy and not simply a tinkering around the edges but, while the SDSR should be resource informed, it should be policy led.

The SDSR is being overseen by the National Security Council and will guide all areas of where security is affected, not just the MoD, and should provide a coherent approach to security and defence across the government. It is intended to address the fact that the UK is currently in conflict but must not be predicated on future conflicts mirroring these current ones and, as such, it should balance the immediate demands in Afghanistan with planning for alternative futures. Inherent in this approach is the need to provide forces, equipment and contracts that allow flexibility in approach while recognising the budgetary constraints. This should therefore see a structural change in the MoD centre and a reconfiguration of the Armed Forces to meet evolving security needs.

Budget outlook – protected for the short term but under threat long term like other departments

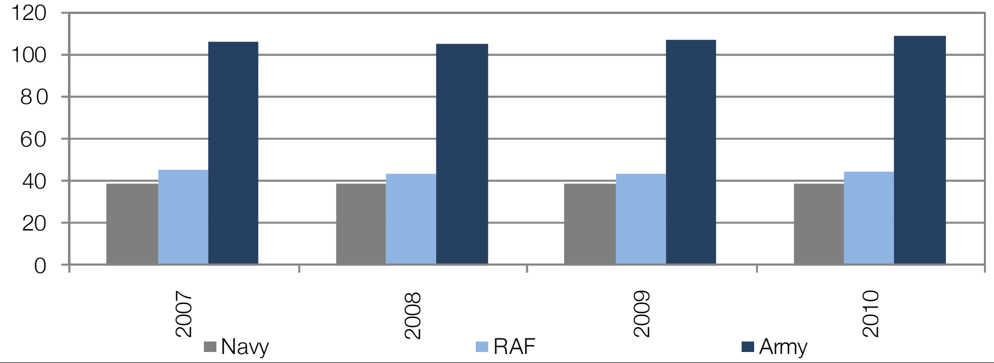
Given the pressures on the UK public finances and the subsequent expectation for each non-protected department to identify savings of between 25-40%, we view it as highly likely that significant savings will need to be made in Defence over the longer term. While there is recognition that short-term cuts of this scale would be difficult with current conflicts ongoing and hence savings of 10-20% have been requested, we highlight the following areas of spend where longer-term budget cuts appear probable in our view:

The Equipment Programme. In our view this is the obvious place to start due to the sheer scale of expenditure in DE&S. Within this £16.8bn, approximately £7bn relates to capital expenditure and c £4bn to equipment support. The latest National Audit Office Major Projects report highlighted that the current defence budget remains overcommitted by £6bn over the next 10 years, assuming an annual increase of 2.7% in the budget after the end of the current CSR settlement in 2010/11. If the budget remains flat in cash terms, this over commitment increases to £36bn. The report also highlighted the fact that previous adjustments to production schedules, while providing short-term cost reductions, increased the overall costs and reduced value for money.

We believe that the only real way to achieve substantial, lasting savings is to cancel or restructure entire programmes, not just re-profile. We view programmes most likely to face cuts as those which are not yet under contract. In terms of re-profiling, we have already seen moves in areas such as the Lynx Wildcat fleet where numbers and flying hours have been reduced. However, as highlighted in the NAO's Major Projects report, this does not necessarily end up as the most efficient method, with the 12% reduction in costs associated with a 23% reduction in numbers.

Force structure and size. The manpower of each of the services are shown in Exhibit 16 and shows the clear size of the Army with c 109k personnel versus the Royal Navy and RAF, which have c 39k and 44k people respectively.

Exhibit 16: Relative manpower of the UK military services ('000s)



Source: Defence Analytical Services and Advice (DASA) – Monthly Manpower Statistics April 2010

One area that we believe could well be targeted as a result of the SDSR is the relative size and structure of the armed forces. In our view the RAF appears most at risk of a downsizing of personnel due to the changing nature of the perceived threat. If this were to be the case, we would also anticipate a range of options to reduce the existing aircraft fleet size which, in turn, could lead to a reduction in the number of aircraft bases around the UK.

Administration costs. Interestingly, of the £2.1bn of administration costs, £1.6bn relates to personnel and the remaining £485m to a wide range of other areas such as logistics, utilities, fuel and other central support. We believe there are significant cost savings that could be achieved through a more effective outsourcing of many of these areas. While it is difficult to establish the true split across each element of the civil service within the MoD, we highlight the fact that of a total contingent of c 273,000 staff, nearly 28%, or 76,000 are civilian, non-frontline MoD employees.

Defence estates. Likewise, the opportunity to reduce the cost of maintaining and running the defence estate, costing an annual £3.6bn, appears to be another area for further scrutiny. Although there is already an element of outsourcing through programmes such as the regional prime contracts and naval base management contracts, this accounts for just under half of the total costs thus far and we anticipate that the scope, duration and reach of many of these contracts may well be extended to seek further areas of cost saving and potential rationalisation of the estate.

Conclusion

In our view, there will undoubtedly be cuts over the longer term to the UK defence budget. However, we believe that such changes will have to be made in partnership with industry due to the combination of its embedded nature, government's reliance on a few key suppliers and the fact that we remain in live conflicts. While equipment choices will have to be made, these will be guided by the SDSR process and an understanding of long-term priorities and choices. We believe the difficulty will be in achieving an appropriate balance between the needs of today versus those of potential future conflicts and, as a result, we anticipate flexibility to be key.

Likewise, we view the cumbersome and costly nature of the MoD centre as ripe for change and Liam Fox has already highlighted as such. However, we feel that industry may well be a net beneficiary of this element of any cuts, particularly those who can demonstrate a commercial approach to cost saving. In short, we view the outlook in the UK as challenging, but also believe that industry will continue to have a significant part to play in the solution.

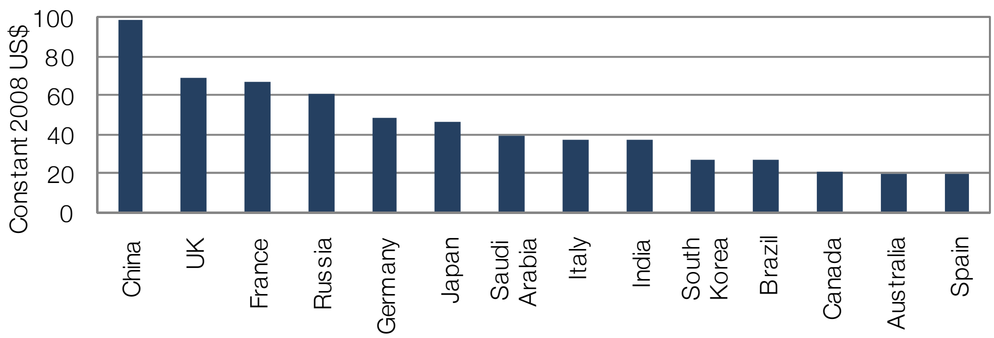
RoW defence – mixed picture signals rush to growth economies

The picture for defence expenditure outside UK industry's key transatlantic markets is one that is mixed, with those in Europe under extreme budget pressure in common with the UK while other areas, most notably in the Middle East and Asia Pacific, remain strong.

Budget history – dominated by established defence nations

Exhibit 17 below shows that the spend outside of the US predominantly occurs in the major established defence nations in Europe such as the UK, France, Germany and Italy or in nations such as China or Russia that are closed to western participation.

Exhibit 17: 2009 Global defence spend - ex US



Source: SIPRI Military Expenditure Database and Edison Investment Research

Budgets – outlook driven by economic reality

Looking forward, we see a divergence in defence spending priorities and budgets across the globe that is due to alter the landscape in the longer term. We feel that those economies severely weakened during the financial crisis are likely to cut budgets, while Middle Eastern and emerging economies are set to press ahead with defence modernisation.

Western economies

Governments across Europe have been hit hard during the financial crisis, and even in those established defence markets we have seen a series of announcements that until only recently would have seemed unthinkable. For example, within France, Germany and Italy we have seen significant moves towards a re-prioritisation of defence budgets and significant cuts, such as an €8.3bn decrease in Germany alone by 2014.

Middle East

The Middle East remains an attractive market due to the combination of oil wealth and a high threat environment with many nations concerned about escalation of conflict in the region, as well as the threat from terrorist activity. As a result, we believe this will remain a key target market for most international defence players.

Asia Pacific

With the emergence of the Asian economies has come a desire to increase the military capability to rival the increasing economic power. In particular we highlight India as a stand-out market with plans to spend at least $30bn on military modernisation by 2012. With equipment contracts being let and a much needed fighter programme currently in competition, the country has attracted significant investment from the global defence primes.

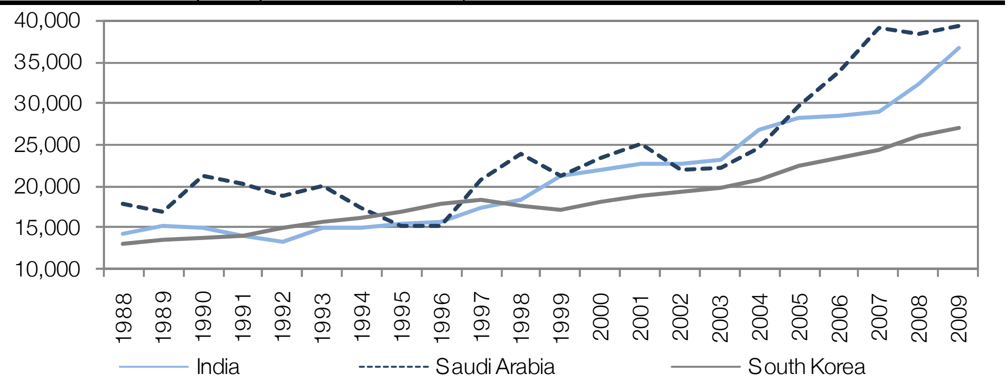
Other

Like India, Brazil is benefiting from a rapidly advancing economy and has further defence spending plans over the next and is already the largest spender in the region by some way, effectively double the nearest competitor Colombia.

Conclusion – key markets of the future

With increasing budgetary pressures in the West, we believe there are a number of countries that will see increasing interest from defence suppliers across the globe. The three key markets we highlight here are India, Saudi Arabia and South Korea. Exhibit 18 below shows how defence spend in these countries has increased rapidly over the past few years and we anticipate this to remain the case.

Exhibit 18: Defence spend (constant 2008 US$)



Source: SIPRI Military Expenditure Database and Edison Investment Research

Although competition in these markets is likely to intensify, we feel that UK industry, with an export market share of c 20%, can punch significantly above its weight, placing it on a par with the US and Russia. Through a combination of existing operations and newly established partnerships in these countries, we feel the UK is well placed to gain a proportion of the emerging opportunities here and elsewhere.

Civil aerospace OEM – Large jets in a game of chess

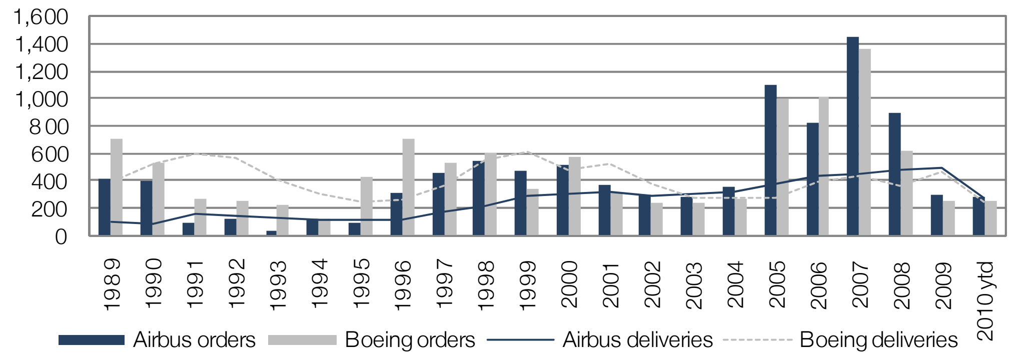
The large jet market is currently a duopoly between Airbus and Boeing and the fortunes and strategy of these two companies drives the direction of the supply chain. Both companies have weathered the downturn with a managed build approach that has seen deliveries flatten but not drop off a cliff, supported by a large backlog built-up over the previous four years.

With new aircraft entering production and a pick-up in orders starting to filter through, we view the outlook as promising, a fact that has encouraged a series of potential new entrants vying for a share of the market. While we believe that some of these may well be a success in their local markets over the longer term, we do not believe the established players will cede control without a fight, a fact we are see being played out in developing product strategies for narrow-body jets.

Order and deliveries – large backlogs still to be delivered

As a result of the order cycle between 2005 and 2007, the total backlog of aircraft grew substantially and now stands at some 6,739 aircraft. Given the combined forecast build rates of c 950 aircraft for Airbus and Boeing, this equates to seven years' production and highlights how the two companies were able to maintain build rates during the economic downturn. We feel the prudent approach to delivering the backlog was not fully recognised by many investors.

Exhibit 19: Historical orders and delivery profile



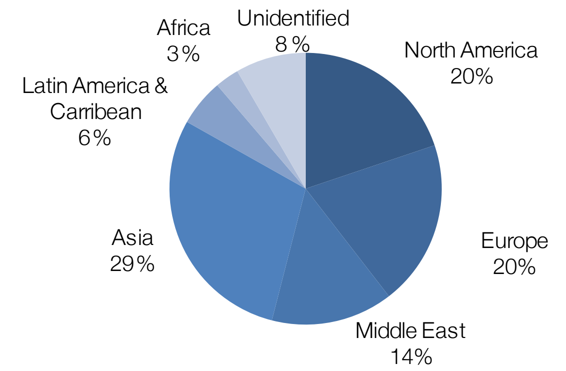
Source: Boeing and Airbus and Edison Investment Research

While gross orders in 2009 reached 573, when cancellations were taken into account this dropped to c 410 giving a book:bill ratio of 0.4x. We anticipate a recovery in orders in 2010 and believe that the book:bill is likely to remain beneath 1x for the year, although not by much, with year-to-date orders approaching the level received throughout 2009 as a whole. Indeed, following orders received at Farnborough Airshow, Airbus increased its full-year order expectations to over 400. Encouragingly Farnborough orders included the return of lessors, which we feel highlights the growing confidence in the airline recovery and shows the inherent pent-up demand for aircraft that exists.

Backlog structure – different from the past

Importantly in our view, the structure of the backlog has altered significantly from the previous peak of the cycle where the backlog was concentrated in the mature US market, which was hit remarkably hard during the last downturn. Exhibit 20 shows this has shifted to emerging markets where economic growth remains intact and the increasing demand for air travel provides a significant driver for aircraft orders.

Exhibit 20: Large jet backlog profile by region



Source: Boeing and Airbus and Edison Investment Research

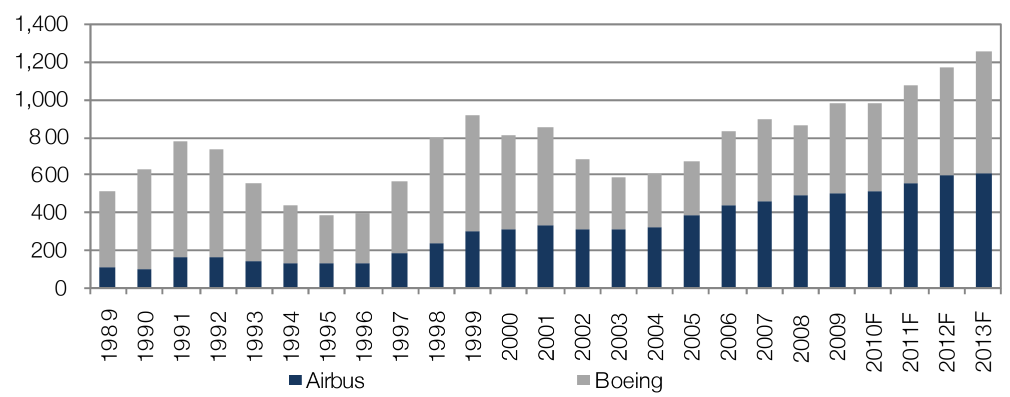
The fundamental drivers are the emerging markets, although we feel there are structural issues at play in North America and Europe that will support a robust outlook in these regions. In North America the ageing fleet is due to enter a significant replacement cycle once airlines feel comfortable that the recovery is sustainable. In both regions there is also the drive towards increasingly fuel-efficient aircraft, with the price of oil predicted to remain around current level, and we note the panic and rush of orders that accompanied the sudden oil price spike that occurred in mid 2008.

Build rates – measured increases expected

Given the improving outlook in commercial traffic and the significant backlog to be delivered, we feel there will be a steadily increasing build rate over the coming years. This is due to the combination of a sustained narrow-body build up, supplemented by the impact of a build-up of new aircraft production across the A380, B787, 747-8 and, subsequently, the A350 in outer years.

Another factor that we feel has played a part in the resilience of the build profile has been the tendency for manufacturers to overbook slots, particularly in the largest narrow-body segment. This has occurred on both the A320 family and the 737 with Airbus recently stating that, at the current production rate of 34 A320s a month, delivery slots are booked out until 2014.

Exhibit 21: Forecast large jet build rates



Source: Boeing and Airbus and Edison Investment Research estimates

The key drivers of our expectations that production volumes will rise over the next few years are as follows.

Narrow bodies. During 2010, both Airbus and Boeing announced planned increases in production rates in the workhorses of airline fleets, the A320 and B737. Airbus is planning to incrementally up production of the A320 family from a current 34/month to 36/month at the end of 2010, 38/month from Q311 and 40/month in Q112. Boeing also announced that production rates of the 737 will increase from 31.5/month currently up to 35/month on 2012. With these increases, we could see an additional build of 120 aircraft a year by 2012.

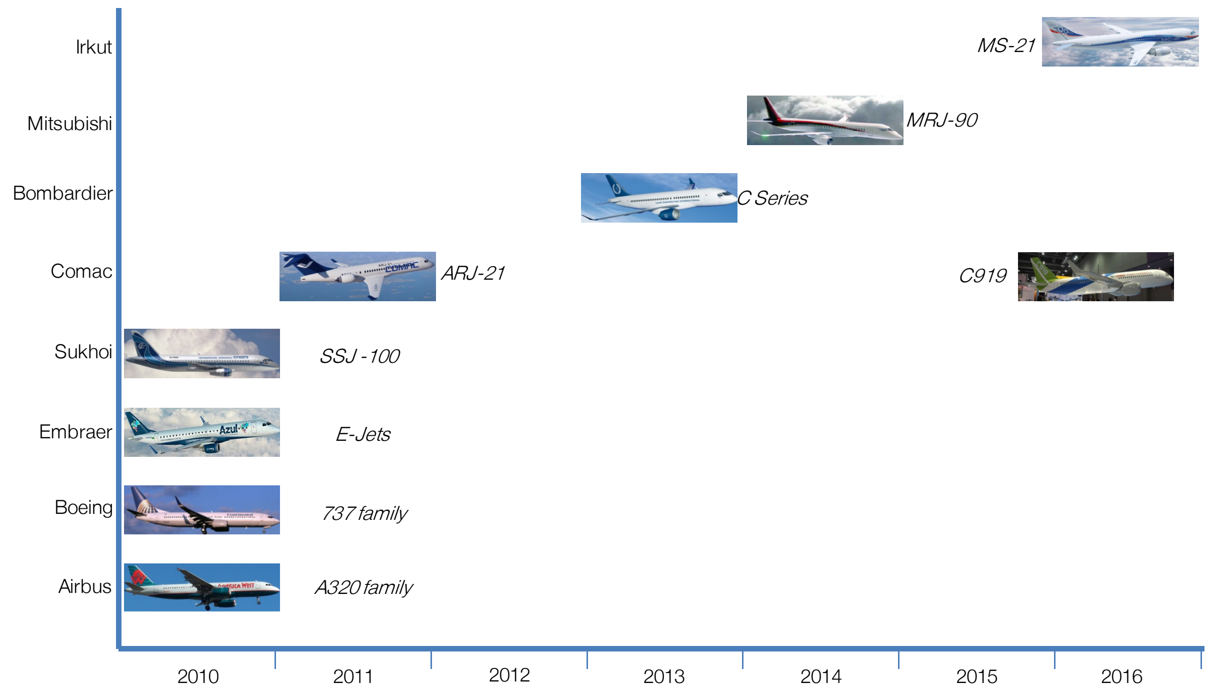
Long-range. We also anticipate a steady ramp-up of A380 build from the 10 delivered in 2009 to two/month and then three/month in 2012 with a possibility of reaching four/month thereafter, adding some 20-30 aircraft a year. Most importantly for managing the supply chain though are the first deliveries of the 787 due in Q1 2011. From here Boeing plans to ramp-up production to a target of 10/month in 2013, potentially adding some 120 aircraft a year.

Even if these were all achieved, the build rate would increase to around 1,250 aircraft a year and so, even without any further additions to the backlog, production would last for over four years at peak rate. Hence we are comfortable that the near-term outlook for civil production is healthy.

New entrants – longer-term threat to duopoly

In the longer term, there are a range of new entrants seeking to attack the established order. These range from established civil aircraft manufacturers such as the Bombardier with its 100-seat CSeries at the lower end of the segment to brand new players that are concentrated at the sub-100 seat or at the upper end of the high volume narrow-body market. Exhibit 22 shows these players and where they fit in terms of offering.

Exhibit 22: New entrants and forecast entry into service



Source: Edison Investment Research

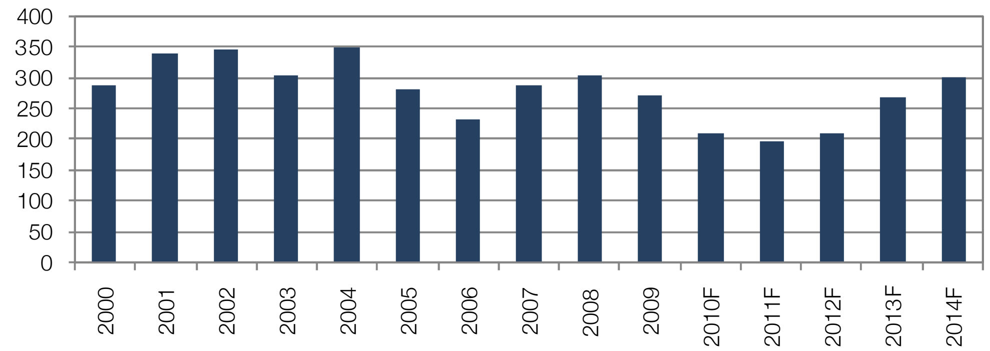
The first significant threat to the lower-end of the A320/737 range is the Bombardier CSeries, which has been optimised for the 100-149 seat range. We believe this aircraft in particular initiated Airbus and Boeing to consider a re-engine of the narrow body fleet as opposed to simply creating a replacement at the start of the next decade. The outcome of this decision is anticipated in the autumn and we believe this is one of the factors that has delayed orders for the CSeries as customers wait to see what competing offerings may be available.

In the longer term, we feel that the Russian, Chinese and Japanese offerings may start to erode some market share, particularly in home markets from the traditional players. However, we believe that both Airbus and Boeing will produce a competitive replacement aircraft to meet these longer-term threats. We believe that the timing of any such decisions, either new-build or a re-engine, will occur once there is sufficient engineering resource at the manufacturers, which will happen once current development finishes on the likes of the A380 and B787.

Regional OEM – developing market strategy

The regional jet market was hit by the recession, although not to the same extent as the business aircraft market. Hence production rates across the two major players, Bombardier and Embraer, who share approximately 90% of the market between them, remained at similar levels to 2008.

Exhibit 23: Regional jet deliveries (units delivered)



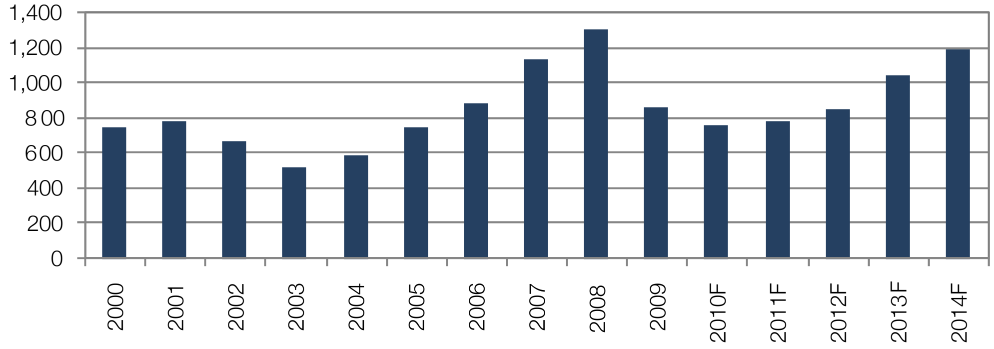
Source: Bombardier and Embraer and Edison Investment Research estimates

While the regional market remains affected by the volatile economic growth, there are several factors at play that provide a positive outlook over the longer term, particularly at the larger end of the regional jet market. With long-term economic growth anticipated to return, airlines are looking to right-size routes in established markets with more cost-effective aircraft and growth is set to rocket in emerging markets through market liberalisation; both Bombardier and Embraer forecast a 20-year demand of somewhere approaching 7,000 aircraft in the segment. Again, we see increasing competition in this market from new entrants, which reverses a trend witnessed over the past decade where previous alternatives such as the BAe-146 and Fokker 100 left the market.

Business jet OEM – volatility remains

The business jet market is probably the most economically sensitive sector in civil aerospace and as a result it remains hugely volatile in terms of aircraft usage, demand and, due to the comparatively short order book, the build cycle. Following the recession we saw a significant decline in business jet fleet statistics and subsequently a rapid decline in build rates at all the major manufacturers, resulting in major restructuring and significant job losses in the industry.

Exhibit 24: Business jet deliveries (units delivered)



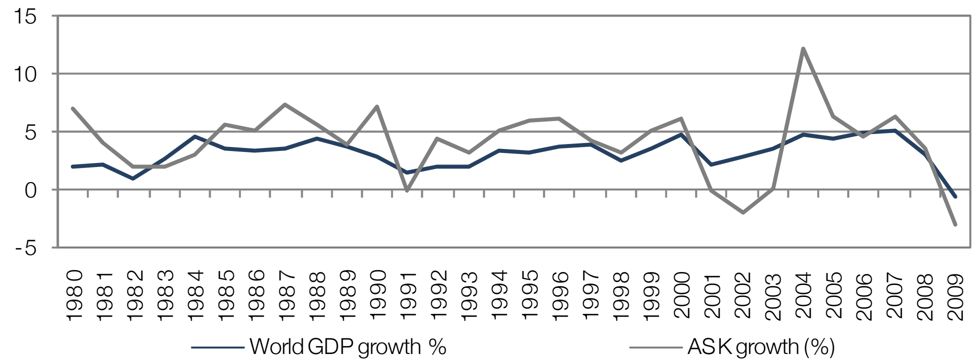
Source: GAMA and Edison Investment Research estimates

Exhibit 24 shows the rapid reversal in deliveries after 2008 and we anticipate that the recovery will remain sluggish, with rates bottoming out in 2010/11 before growth resumes in the outer years. Even with a recovery, we do not forecast a return to the peak rates witnessed in 2008 over the next five years.

Civil aerospace aftermarket – linked to economic recovery

There is a very strong correlation between air traffic capacity and global economic growth. Given that the vast majority of aftermarket revenues are driven by the number of aircraft in service and the amount of activity that the fleet undertakes, we view Available Seat Kilometres (ASKs) as a good proxy for aftermarket revenues in general, at least in terms of trends.

Exhibit 25: ASK history



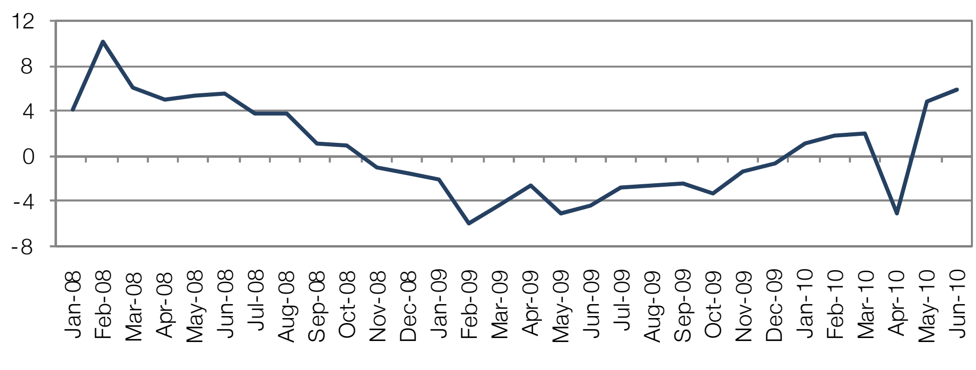
Source: IATA, ICAO and Edison Investment Research

Exhibit 25 highlights the long-term trend in ASKs when compared to global GDP growth. The historical average trend is around 5% pa increase in ASKs. While there have been several instances where this figure has significantly decreased, such as the first Gulf War, after 9-11 and during the recent financial crisis, the industry has traditionally returned to trend in a very short space of time. The big question we face today is the pace at which industry will return to trend given the enduring nature of the economic crisis.

Short-term ASK trend

Since the start of the financial crisis we have seen a rapid decrease in ASK comparators as the recession impacted global travel demand, which in turn forced airlines to rapidly cut capacity to reduce losses. The impact of this was to send ASK growth negative for a sustained period of time resulting in net-negative annual growth, the scale of which was unprecedented. However, towards the end of 2009 the trend started to reverse with decent momentum and growth returned positive at the beginning of 2010. Exhibit 26 below displays the rebound in growth. Note, however, the temporary negative month in April 2010 as a result of the Icelandic volcano.

Exhibit 26: ASK history – monthly year-on-year progress



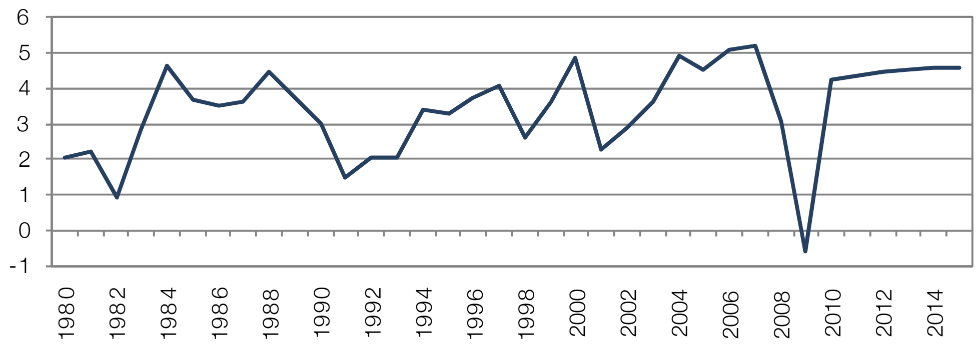
Source: IATA and Edison Investment Research

We feel that the indicators for an increase in capacity are positive with passenger volumes now at 1-2% above pre-recession levels and load factors improving to a historic highs suggesting further capacity will be added going forward. Likewise, with IATA forecasting that airline profitability is set to return in all regions except Europe, we view the outlook for demand being matched by capacity increases as improving.

GDP outlook – uneven recovery

The outlook for the world economy remains uncertain and patchy, although growth is anticipated to return following the economic crisis of the past two years. Exhibit 27 demonstrates the severe downturn and highlights that the IMF anticipates growth will resume from late 2010 onwards.

Exhibit 27: Global GDP outlook (annual % change)



Source: IMF and Edison Investment Research estimates

While global growth is expected to resume, the regional outlook remains varied, with significant growth anticipated in Asia Pacific in particular and growth in Europe expected to remain slow.

Conclusion – aftermarket recovery slower than normal

With economic growth likely to remain uncertain and volatile, we anticipate that airlines will continue to be cautious about adding back capacity to their networks ahead of clear, sustained demand. As a result, we believe aftermarket revenues may well return at a slower rate than in previous upturns. However, we would point to the fact that the impact on each company depends on the structure of where their aftermarket revenues are concentrated. This is the case both in terms of in which areas of the world those revenues are derived and the particular types of aircraft on which those revenues depend. Overall, we continue to view the aftermarket as an attractive revenue stream over the long term.

Investment appraisal – industry exposure

We believe that the industry currently provides investment opportunities to suit a range of styles with the combination of the noise surrounding defence budgets and the nascent commercial recovery accentuating differences across the sector. Here we identify the main drivers for each company and highlight which ones are exposed to the various sub-sectors within aerospace & defence and how that will impact the outlook and investment view.

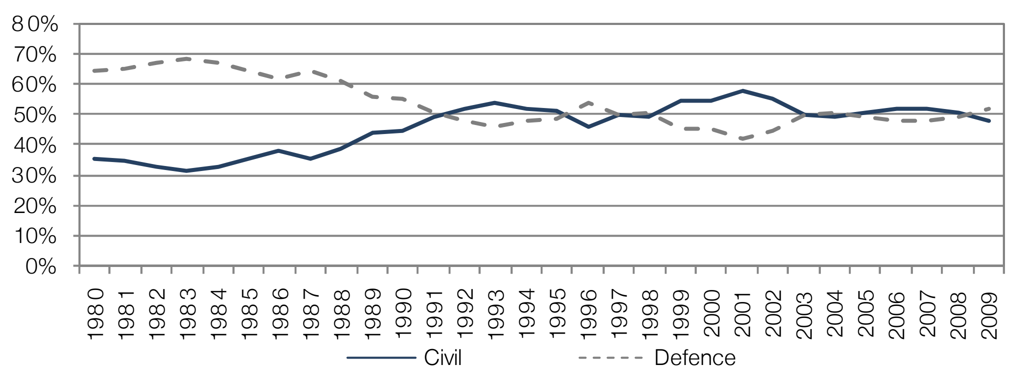
Defence / Civil exposure

The UK industry is involved in both civil and defence manufacturing and as Exhibit 28 below shows, for the past decade the split has effectively been 50:50.

While there are no longer any civil aircraft OEMs, the industry is very successful in the supplier levels and, through Rolls-Royce, has one of the two major global engine manufacturers. In defence, prime manufacturing is dominated by BAE Systems which has activities across Air, Land and Sea, providing the UK with an ability to manufacture systems on its own where necessary. The extent to which this is deemed necessary in the SDSR and update to Defence Industrial Strategy will determine how long this remains the case.

International companies also have a significant presence in both Civil and Defence with the likes of EADS, Finmeccanica, Thales, General Dynamics, Lockheed Martin, Boeing, Northrop Grumman, Raytheon and CAE having a noticeable presence in the market.

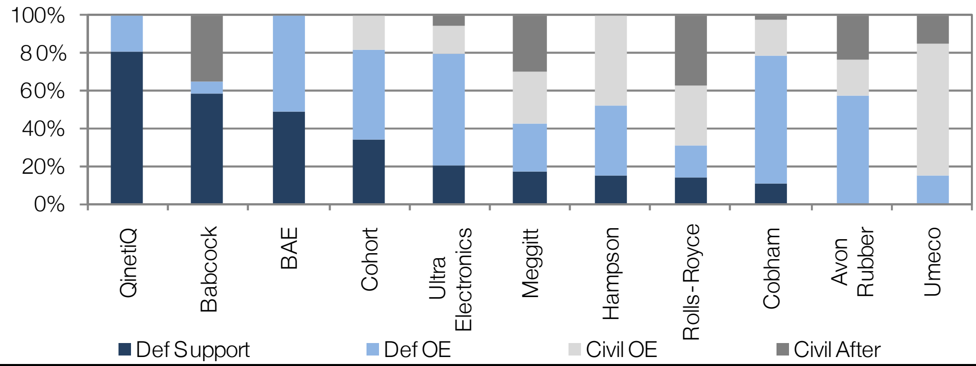
Exhibit 28: Proportion of UK industry sales by end market



Source: UK ADS Survey 2010

In terms of UK companies within the sector, Exhibit 29 highlights the exposure to civil and defence both in terms of sales into original equipment and in the aftermarket/support arena.

Exhibit 29: Defence / civil sales split by company



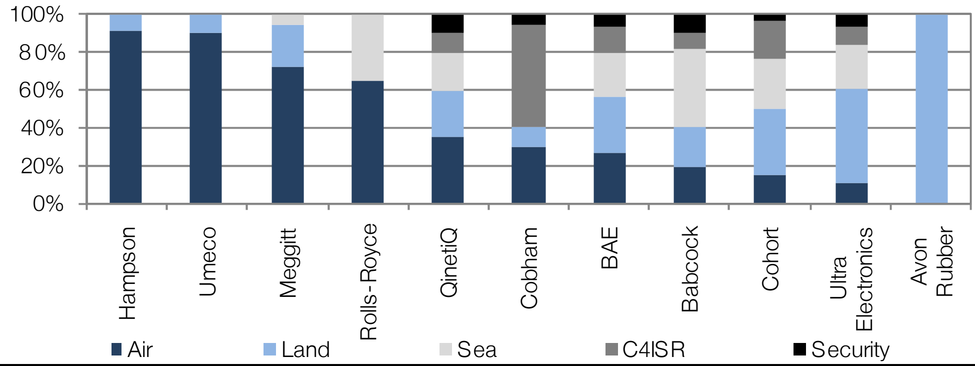
Source: Edison Investment Research estimates

In terms of those most exposed to the various end markets, we make the following observations:

- Defence Support. We believe there may well be an opportunity for companies to gain an increasing share of the outsourced defence market. We feel the UK government will look for ways to reduce direct headcount and increasingly require industry to provide solutions to reduce costs. The best positioned company in our view to capitalise on this is Babcock due to its wide spread of activities and demonstrable achievement of savings. QinetiQ may also see some benefits but we remain wary of its position in general.
- Defence OE. The defence OE market will undoubtedly see some softening as new build platforms require significant investment. However, we believe that those platforms already under contract will remain in production but may see some deferrals or reductions in numbers. If this is the case, we feel that the export market may provide a route for reductions in government spending while maintaining the workload for the industry. We see BAE Systems as the most directly impacted; however, we feel that its global nature will provide an element of resilience to any UK cuts. We note that Ultra Electronics, while involved in many platforms, has no single programme that accounts for >5% of revenues.
- Civil OE. The civil OE market is dominated by Airbus (EADS) and Rolls-Royce. This portion of the market provides a long tail of business in the supply chain and this provides support to many of the smaller companies in the UK industry such as Umeco and Hampson. We do point out, however, that despite the significant position of Rolls in civil manufacture, the business is actually much better balanced than one may expect. As the civil market picks up again, we feel the smaller suppliers will be the greatest beneficiaries.
- Civil aftermarket. The civil aftermarket provides a healthy, cash-generative income stream to those companies involved but can be more volatile to economic activity as witnessed following the recession. As confidence returns and aircraft traffic increases, we anticipate that Meggitt will see the quickest recovery as its products are high wear and safety critical.

We have estimated the breakdown of each company's defence exposure to the different armed forces, joint operations in C4ISR (Command, Control, Communications, Computers, Intelligence, Surveillance & Reconnaissance) and in the rapidly increasing security field.

Exhibit 30: % Defence sales by activity



Source: Edison Investment Research estimates

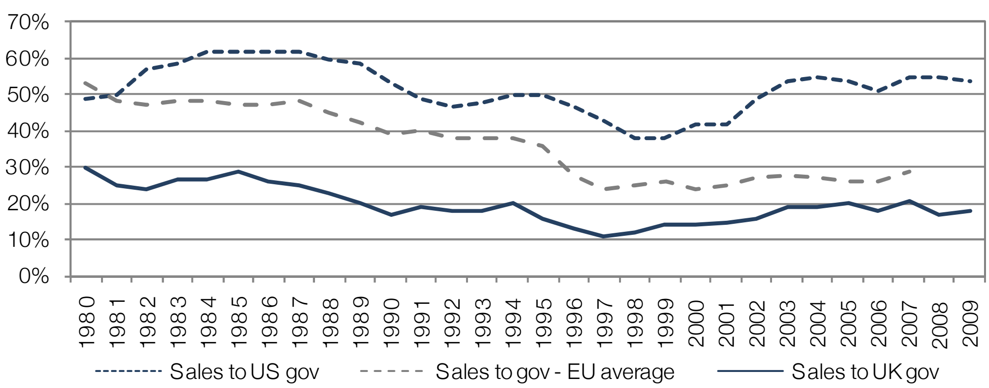
As Exhibit 30 shows, there is a wide spread of activity ranging from those predominantly involved in a single sector (**Avon Rubber, Hampson, Umeco**) through to companies with activities across all sector (**BAE, Babcock, Ultra, QinetiQ, Cohort**). We feel that in this environment the breadth offered by these larger companies provides an element of resilience to any sector-specific shocks. However, the flip side is that these companies are likely to see some impact of cuts due to their widespread nature.

We highlight those companies involved in particular in the C4ISR and security markets as we believe these are areas that should continue to see healthy growth. We feel the C4ISR market is due to continue its growth as information superiority and situational awareness becomes increasingly important on the battlefield. In this respect, we highlight **Cobham** and **Ultra** in particular as a potential beneficiaries. While security is still an evolving subsector, we believe the convergence of traditional security and defence markets is likely to continue apace.

Global businesses in a global market

Another feature that is important to understand is the global nature of the UK aerospace & defence industry and how this will influence the true effect any weakness in the UK will have on certain companies. As Exhibit 31 below demonstrates, UK industry is less dependent on its home market than either the US or wider European industry with only 20% of sales derived from the UK government.

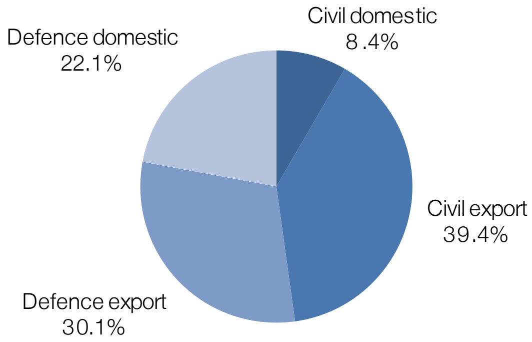
Exhibit 31: Proportion of indigenous industry turnover delivered to home government



Source: UK ADS Survey 2010

We feel that this is due in part to the fact that industry has become adept at managing a tightening budget and, as a result, has been diversifying into the global market largely through acquisitions. The industry is also well respected in the export market, with the UK traditionally taking a 20% share in defence exports for example. This places UK industry at the forefront of this market with a share equivalent to the US and Russia.

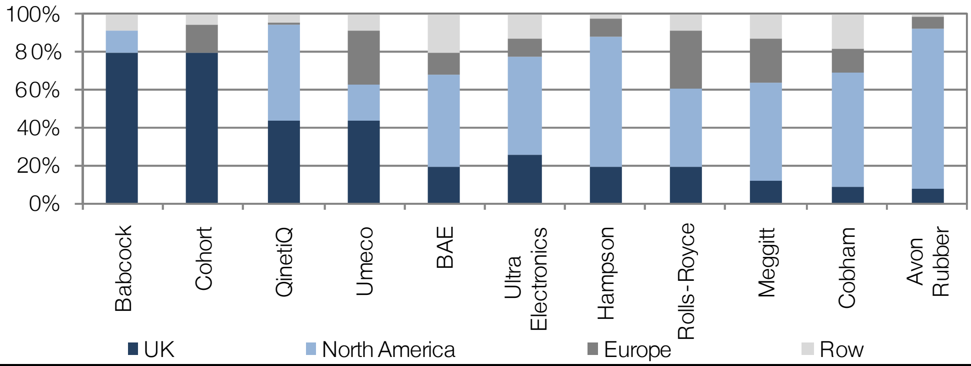
Exhibit 32: UK industry revenue sources



Source: UK ADS Survey 2010

Due to this long-held global outlook, there are few companies that are wholly exposed to the UK market and Exhibit 33 below highlights this.

Exhibit 33: Company revenues by destination



Source: Edison Investment Research estimates

We highlight the following in terms of the regional exposure of the companies:

- UK market. The companies with the largest exposure to the UK are Babcock, Cohort, QinetiQ and Umeco. While most companies have been diversifying away from the UK Babcock, through the acquisition of VT Group, actually became more entrenched. While this may seem an odd time to make such a move, we support the idea that having such a scale in defence outsourcing at this time could provide a real opportunity. Of the other companies, we are concerned about the impact of delays on both QinetiQ and Cohort and, indeed, the fact that there is a large amount of consultancy work at these companies, which is an easy hit in a tightening environment.
- North America. With the sheer size of the North American market and the natural benefit of a common language, it is no surprise that UK companies have a significant presence in this the largest aerospace & defence market. As a result there are a number of companies

that actually derive much greater revenues from the US than anywhere else. In particular, we highlight BAE Systems, Cobham, Ultra Electronics, Hampson, Meggitt and Avon Rubber, all of which derive >50% of their revenues from the US. We feel that these companies will be less affected by a slowdown in spend with each company still having significant room for further expansion in this market. As a result, we anticipate much of the acquisition activity to remain centred on this market.

- Europe. Due to the largely closed nature of the European defence market, the vast majority of sales to the region are derived from the commercial market. There are pockets of opportunity beyond this but we do not foresee a significant change in this stance, particularly as European governments adopt a more home-industry focused approach than the much more open UK market.
- RoW. We believe that with potential declines in the UK and growth slowing in the US, industry is targeting higher growth emerging markets and those with robust budgetary environments. In particular, UK firms are heavily targeting India, the Middle East and Australia. While this is most visible through BAE Systems' "home market strategy" we believe that this will be an increasing trend across the industry.

Currency impact

Given the global nature of the industry, currency is also a factor. The following table highlights the sensitivity to exchange rates:

Exhibit 34: Currency sensitivities

	US$ sales	1 cent move on EBITA (+/- £k)	As proportion of 2011 EBITA	€ sales	1 Eurocent move on EBITA (+/- £k)	As proportion of 2011 EBITA
BAE Systems	51%	6,500	0.3%	5%	-	-
Cobham	60%	700	0.2%	13%	200	0.1%
Rolls-Royce	Transaction	11,000	1.0%			
Avon Rubber	86%	50	0.4%	6%	-	-
Babcock	11%	200	0.1%	<1%	-	-
Chemring	47%	300	0.2%	15%	230	0.1%
Cohort	0%	-	-	10%	-	-
Hampson Ind	69%	250	1.1%	10%	2	-
Meggitt	52%	900	0.3%	23%	200	0.1%
QinetiQ	51%	400	0.3%	1%	-	-
Ultra	53%	400	0.3%	9%	40	-
Umeco	19%	20	0.1%	28%	20	0.1%

Source: Edison Investment Research estimates

As can be seen, the US dollar dominates. We highlight that Hampson is most sensitive to currency variations and that Rolls-Royce is benefitting from the unwinding of its hedge book at better achieved rates, which should create a tail wind of 6-9 cents in 2011.

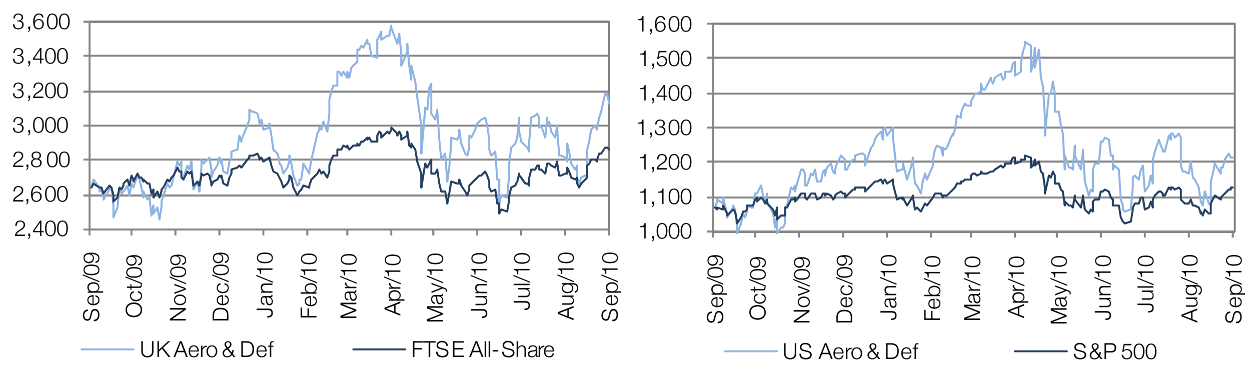
Sector performance and valuation

Aerospace & defence has had, like many other sectors, a turbulent ride over the past three years. Following the initial buffeting of the civil sub-sector as severe concerns about the economy took their toll in 2008, the sector recovered well in general over the past 12 months. We are now in a period of recovery in civil, while concerns now centre on the outlook for defence spending. This has caused some volatility, but we feel it has also provided some opportunities, akin to the position the civil-focused stocks were in 18 months ago.

Relative performance

The sector on both sides of the Atlantic has followed a broadly similar pattern over the past 12 months. The initial signs of recovery in the early part of 2010 gave way to a more cautious position, as the strength and depth of economic recovery was questioned and the relief that surrounded good earnings figures gave way to a focus on the impact of government austerity measures.

Exhibit 35: UK & US aerospace industry relative share price performances



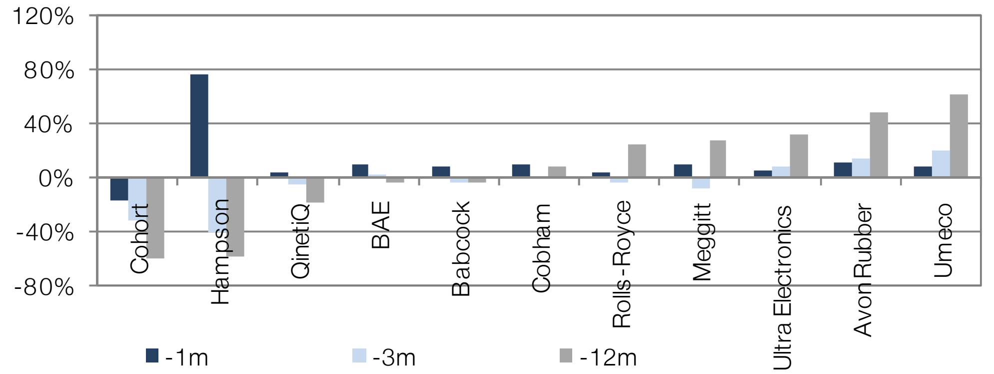
Source: Bloomberg, Edison Investment Research

We believe that there will continue to be volatility in the performance of the sector as a whole as the economic recovery may well be staccato in nature and at times provide conflicting signals for growth. We also feel that the sector will be continue on a twin-track path with civil-focused stocks more likely to outperform in the short-term as negative noises surrounding defence spending continue to provide the backdrop leading up to the UK's Comprehensive Spending Review in October. We do feel, however, that many of the more defence focused stocks could well provide good long-term returns as the full impact of changes become known.

UK stock-specific performance

The UK sector has, on the whole, performed well over the past 12 months, outperforming the FTSE All-Share by 9%. There have, however, been some casualties with Cohort, Hampson and QinetiQ having waned on profits during that time, with the shares down 60%, 59% and 20% respectively. At the other end of the scale we have seen good performance from the civil plays that had been so heavily hit previously, with Umeco, Meggitt and Rolls-Royce up 61%, 26% and 23% respectively, and those that had demonstrated resilience and growth such as Ultra Electronics, up 31%, and Avon Rubber up 48%.

Exhibit 36: UK company share price performance



Source: Bloomberg, Edison Investment Research

One of the major concerns that had been driving the relative performance was the level of debt, combined with a slowing market. This hit Hampson in particular, in the end having to raise equity in February 2010. On the other hand, Umeco provided an example of the rebound that can happen when such concerns are overcome.

Debt concerns reducing for most

The table below highlights the current financial position of the UK aerospace & defence industry. In general the concerns that had plagued the sector due to perceived high levels of gearing and little headroom over covenants have been removed as companies have concentrated on stricter working capital management and reduced debt levels to more manageable levels.

Exhibit 37: Financial position of UK companies

	Cash conversion (%)		FCF (£m)		Net (debt) / cash (£m)		Gearing (%)		Interest cover (x)		Net debt/EBITDA (x)	
	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010
FTSE 100												
BAE Systems	88%	71%	1,284	871	403	(97)	(9%)	2%	11.4	11.9	(1.5)	(0.7)
Cobham	88%	97%	209	234	(413)	(248)	44%	24%	8.1	7.6	1.1	0.6
Rolls-Royce	46%	59%	344	430	1,275	1,176	(17%)	(20%)	14.5	17.3	(0.5)	(0.7)
FTSE Mid/Small Cap												
Avon Rubber	77%	56%	2	2	(14)	(15)	25%	26%	4.8	7.6	1.4	1.2
Babcock	105%	67%	135	93	(302)	(817)	352%	92%	8.9	5.2	1.6	2.5
Chemring	93%	90%	44	30	(123)	(301)	80%	51%	8.9	7.1	0.9	1.9
Cohort	16%	98%	0	4	3	5	(7%)	(10%)	28.9	23.3	(0.7)	(0.8)
Hampson Ind	53%	71%	16	(6)	(82)	(86)	29%	32%	4.3	2.4	2.0	3.0
Meggitt	106%	95%	155	109	(809)	(813)	63%	62%	5.5	5.6	2.4	2.3
QinetiQ	115%	73%	103	47	(457)	(431)	97%	92%	3.5	4.5	2.7	2.4
Ultra	117%	94%	93	71	(29)	2	16%	(1%)	12.4	14.2	0.3	(0.0)
Umeco	177%	88%	45	14	(80)	(75)	45%	41%	4.7	5.4	2.1	1.9
Average	90%	80%	n/a	n/a	n/a	n/a	60%	33%	9.7	9.3	1.0	1.1

Source: Edison Investment Research estimates

There are a couple of points we would make reading the industry:

1) Cash conversion is generally strong. With an average conversion rate of >80% and many up in the 90s, the industry as a whole is cash generative. This provides the opportunity to

reduce debt whenever it is deemed necessary and it provides self-sustaining funds for re-investment.

2) Higher levels of gearing are not a concern. Many companies within the sector will make acquisitions as part of their strategy. Typically, the level of gearing can be brought back down under control within a few years.

3) Net debt/EBITDA. Only two companies appear to be cutting it fine with respect to covenants, Hampson and QinetiQ. The latest contract awards at Hampson should provide some comfort that the covenants will be met when they are reduced back down to 3.0x in March 2011 and the restructuring plan at QinetiQ is focusing very much on reducing net debt/EBITDA to beneath 2x.

4) Acquisitions are back on the agenda. With the concerns over debt reducing and with many in the industry sitting with cash or virtually nil gearing, we would not be surprised to see the pace of acquisition activity pick back up again 2011.

Global peer group

We now look at the relative standing of the UK industry with respect to global peers. These span a wide variety of companies, encompassing both pure plays and divisions within much larger conglomerates. We have grouped the companies below in terms of tier and focus, where possible, to allow relative ratings to be more easily understood and discrepancies to be identified.

Exhibit 38: Prime contractors

	P/E			EV/EBITDA		
US	2009	2010	2011	2009	2010	2011
Boeing	34.4	16.5	13.3	14.4	8.2	7.2
Lockheed Martin	8.4	9.7	9.4	5.4	5.4	5.5
Nothrop Grumman	10.9	8.6	8.8	5.8	5.0	4.7
General Dynamics	10.1	9.4	8.9	6.0	5.7	5.6
Textron	40.3	35.5	15.0	11.7	14.0	10.6
Europe						
BAE Systems	8.3	7.8	7.3	4.9	4.8	4.6
EADS	n/a	25.6	16.3	0.7	3.1	2.6
Finmeccanica	7.5	7.5	6.8	4.1	4.0	3.8
Saab	14.6	10.0	8.3	3.8	4.1	3.8
RoW						
Bombardier	13.6	11.5	9.3	6.2	5.3	4.7
Embraer	9.8	35.6	15.9	7.0	11.2	9.0

Source: Edison Investment Research

Within the prime contractors there is a clear valuation gap between US and European firms, with the largest US pure plays trading on an average CY11 P/E ratio of 9.7x and EV/EBITDA of 6.0x. This compares to BAE Systems which trades at a 20%+ discount despite a significant presence in the US market. Bombardier and Embraer are both involved in the regional and business jet markets which have been weak of late, but are in the process of recovery, hence the higher P/E ratios seen here.

Exhibit 39: Electronics/avionics

	P/E			EV/EBITDA		
	2009	2010	2011	2009	2010	2011
US						
Raytheon	9.3	10.9	8.9	4.9	5.6	5.0
Eaton	30.9	15.9	13.2	16.0	9.5	8.4
Esterline	15.4	14.1	13.0	9.0	8.0	7.3
Honeywell	13.1	17.4	14.4	8.9	8.7	7.8
ITT Corp.	11.2	11.2	10.3	5.8	5.8	5.4
L-3 Communications	9.3	8.7	8.0	6.0	5.6	5.5
Rockwell Collins	15.3	15.9	14.0	9.4	9.3	8.4
Europe						
Barco	n/a	14.7	9.3	17.3	4.6	3.6
Cohort	6.8	6.5	5.7	4.2	4.0	2.9
Thales	29.7	15.4	9.5	9.1	5.8	4.4
QinetiQ	8.8	8.9	7.8	7.2	6.7	5.8
Ultra Electronics	17.2	16.0	14.2	10.8	9.7	8.4
RoW						
CAE	15.8	16.8	15.0	8.0	8.4	7.7
Elbit Systems	10.2	11.1	10.5	6.2	6.6	6.2

Source: Edison Investment Research

The electronics and avionics subsector has traditionally held a much higher rating than the prime contractors and this can be seen yet again with the US industry trading on an average CY11 P/E ratio of 11.6x and EV/EBITDA of 6.8x. In Europe, we can see the relative weakness of the more UK, service-focused plays of QinetiQ and Cohort while Ultra Electronics is the most highly valued play across the subsector. One company we would highlight is CAE, the Canadian provider of full flight simulators and training services, for which we see a return to growth as the civil recovery takes hold and militaries around the globe seek to improve flight training while also reducing costs.

Exhibit 40: Systems/subcontractors

	P/E			EV/EBITDA		
	2009	2010	2011	2009	2010	2011
US						
Alliant Techsystems	8.2	7.9	8.2	5.4	5.4	5.5
BE Aerospace	19.2	19.8	15.6	11.7	10.9	9.2
Ducommun Inc.	12.9	11.1	10.0	5.7	5.3	5.0
FLIR Systems	17.8	18.0	15.6	10.2	9.4	8.3
Goodrich	15.7	16.1	13.9	8.7	8.0	7.3
LMI Aerospace	13.0	11.4	9.9	6.6	6.0	5.4
Moog	15.3	14.1	n/a	9.5	8.0	n/a
Pall Corp.	21.7	18.4	15.8	11.6	10.4	9.6
Spirit Aerosystems	12.7	11.6	9.7	7.6	6.3	5.3
Telephonics (Griffon Corp)	33.1	20.5	N/A	6.4	3.7	n/a
Triumph Group	23.4	14.4	10.5	10.1	5.8	4.4
Europe						
Avon Rubber	9.2	7.5	n/a	5.2	4.1	n/a
Babcock	11.2	10.5	9.0	12.7	7.8	8.9
Cobham	12.5	11.8	10.9	8.0	7.0	6.2
Chemring	13.5	11.4	9.8	8.2	7.9	6.4
Hampson	2.5	6.0	6.4	5.9	4.2	3.9
Meggitt	11.6	11.6	10.4	8.1	7.9	7.1
Umeco	11.7	11.6	10.2	9.7	8.2	7.3
Zodiac	16.2	17.6	13.4	11.2	10.7	8.5
RoW						
Heroux-Devtek	10.5	11.5	10.0	4.2	4.1	3.8
Magellan Aerospace	2.0	7.7	6.8	3.9	3.3	3.0

Source: Edison Investment Research

Systems and subcontractors tend to be more closely aligned with the sentiment on major programme outlook across both the civil and military markets. In particular we would highlight the impact of the outlook on civil for Umeco and Hampson and UK defence spending on Babcock and Chemring. The one discrepancy we would highlight is the relative rating of Meggitt and Goodrich which are essentially similar companies with **Meggitt currently trading at a 25% discount to Goodrich** on a P/E basis.

Exhibit 41: Engine manufacturers

	P/E			EV/EBITDA		
	2009	2010	2011	2009	2010	2011
US						
General Electric	13.3	14.8	12.7	26.9	20.6	18.9
United Technologies	15.2	15.0	13.2	9.2	8.0	7.4
Europe						
MTU	15.3	13.2	11.1	6.5	6.2	5.7
Rolls-Royce	14.5	14.6	13.0	7.3	6.9	6.2
Safran	13.3	17.6	12.9	7.5	7.5	6.2

Source: Edison Investment Research

The engine manufacturers have on the whole weathered the civil storm quite well and in particular we would highlight the **resilience exhibited by Rolls-Royce** during the recession. We believe this has removed some of the last major concerns about the business model and as a result, it is now trading at a premium to the other European players and more in-line with the US conglomerates.

Exhibit 42: MRO/aftermarket

	P/E			EV/EBITDA		
	2009	2010	2011	2009	2010	2011
AAR Corp	12.7	13.8	10.9	7.6	7.1	5.7
HEICO	32.1	28.2	24.7	12.1	10.3	n/a
Satair	12.3	7.6	6.2	18.9	17.5	14.8
ST Engineering	22.0	20.5	19.0	13.4	12.7	11.8

Source: Edison Investment Research

The MRO and aftermarket subsector is still a developing one with many operations still undertaken in-house while the push for outsourcing has been delayed due to the civil downturn. We do believe however that longer-term opportunities for further outsourcing of aftermarket activity will continue.

UK valuation summary

The key valuation metrics for the sector are set out in the tables below, along with the operational performance.

Exhibit 43: UK company valuation metrics

	Market Cap (£m)	Share Price (p)	EV/Sales 2009	EV/Sales 2010	EV/Sales 2011	EV/EBITDA 2009	EV/EBITDA 2010	EV/EBITDA 2011	P/E 2009	P/E 2010	P/E 2011	Div Yield 2009	Div Yield 2010	Div Yield 2011	FCF Yield 2009	FCF Yield 2010	FCF Yield 2011
FTSE 100																	
BAE Systems	11,711	333	0.5	0.5	0.5	4.9	4.8	4.6	8.3	7.8	7.3	4.8%	5.3%	5.6%	11.0%	7.4%	7.7%
Cobham	2,691	235	1.7	1.5	1.3	8.0	7.0	6.2	12.5	11.8	10.9	2.3%	2.6%	2.8%	7.8%	8.7%	7.7%
Rolls-Royce	10,740	577	0.9	0.9	0.8	7.3	6.9	6.2	14.5	14.6	13.0	2.6%	2.8%	3.0%	3.2%	4.0%	4.4%
FTSE Mid/Small Cap																	
Avon Rubber	42	143	0.5	0.5	0.5	5.6	4.4	3.6	9.8	7.8	6.9	0.0%	0.0%	0.0%	1.8%	2.5%	0.5%
Babcock	1,998	548	1.2	1.2	0.9	12.7	7.8	8.9	11.2	10.5	9.0	2.6%	3.2%	3.5%	6.7%	4.6%	6.0%
Chemring	979	2,967	2.2	2.1	1.5	8.2	7.9	6.4	13.5	11.4	9.6	1.4%	1.6%	1.9%	2.6%	3.2%	4.5%
Cohort	26	65	0.3	0.3	0.3	4.2	4.0	2.9	6.7	6.5	5.7	2.7%	3.2%	3.1%	26.6%	0.9%	15.4%
Hampson Ind	50	31	0.8	0.7	0.8	5.9	4.2	3.9	2.5	6.0	6.4	8.0%	10.4%	0.0%	2.0%	32.3%	(11.3%)
Meggitt	1,985	294	2.4	2.4	2.3	8.1	7.9	7.1	11.6	11.6	10.4	2.9%	2.9%	3.6%	7.8%	5.5%	5.7%
QinetiQ	712	109	0.8	0.7	0.7	7.2	6.7	5.8	8.8	8.9	7.8	4.4%	1.5%	2.8%	16.7%	22.2%	12.3%
Ultra	1,129	1,655	1.8	1.6	1.4	10.8	9.7	8.4	17.2	16.0	14.2	1.9%	2.1%	2.3%	3.2%	1.3%	3.4%
Umeco	210	437	0.8	0.7	0.7	9.7	8.2	7.3	11.7	11.6	10.2	4.0%	4.0%	4.1%	3.3%	21.3%	6.9%
Average			1.2	1.1	1.0	7.7	6.6	5.9	10.7	10.4	9.5	3.1%	3.3%	2.7%	7.7%	9.5%	5.3%

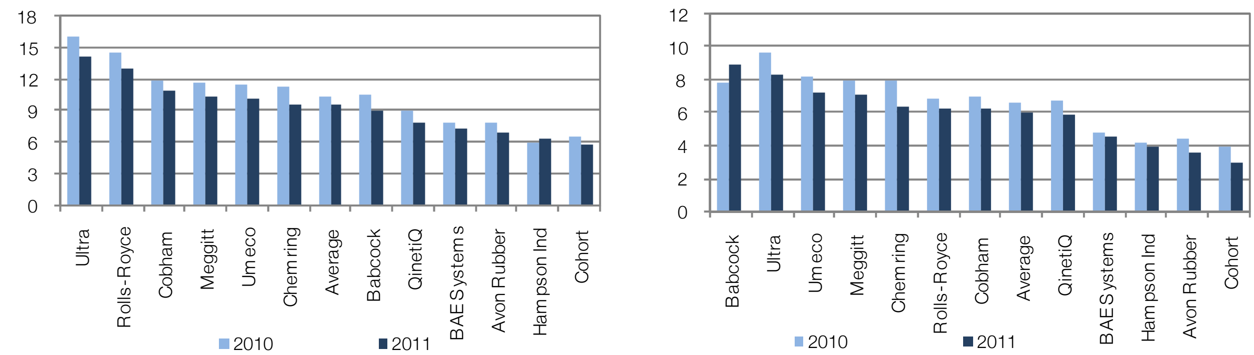
Source: Edison Investment Research

Exhibit 44: UK company operational performance

	Sales (£m)			EBIT (£m)			EPS (p)			DPS (p)			3-yr CAGR to 2011 (%)				EBIT margin	ROACE
	2009	2010	2011	2009	2010	2011	2009	2010	2011	2008	2009	2010	Sales	EBIT	EPS	DPS	2009	2009
FTSE 100																		
BAE Systems	21,990	22,929	23,119	2,197	2,267	2,329	40.1	42.8	45.4	16.0	17.5	18.5	8%	7%	7%	8%	10%	18%
Cobham	1,880	1,982	2,108	337	358	388	18.8	19.9	21.6	5.5	6.0	6.6	13%	16%	12%	10%	18%	14%
Rolls-Royce	10,108	10,813	11,462	983	1,036	1,154	39.7	39.6	44.4	15.0	16.2	17.5	8%	8%	7%	7%	10%	26%
FTSE Mid/Small Cap																		
Avon Rubber	101	105	111	7	10	11	14.5	18.3	20.8	0.0	0.0	0.0	27%	25%	20%	0%	9%	10%
Babcock	1,902	1,896	2,999	147	164	278	41.9	51.4	52.7	14.4	17.6	19.0	24%	32%	16%	18%	9%	27%
Chemring	504	607	797	115	142	175	212.7	251.7	304.2	43.0	48.0	56.0	31%	27%	24%	17%	23%	21%
Cohort	77	78	78	6	4	6	12.8	8.1	10.8	1.8	2.1	2.0	11%	(2%)	(10%)	11%	5%	8%
Hampson Ind	257	178	170	47	32	22	18.5	10.6	3.4	2.5	3.3	0.0	3%	0%	(36%)	(100%)	18%	6%
Meggitt	1,151	1,156	1,213	286	290	314	25.3	25.3	28.3	8.5	8.5	10.5	1%	2%	2%	8%	25%	10%
QinetiQ	1,617	1,625	1,665	152	120	126	15.9	11.1	12.6	4.8	1.6	3.0	7%	(0%)	(2%)	(11%)	7%	10%
Ultra	651	714	765	97	106	117	96.4	103.3	116.3	31.2	34.5	38.2	14%	15%	13%	14%	15%	28%
Umeco	411	409	422	35	32	32	39.7	36.6	38.2	17.5	17.5	18.0	8%	6%	1%	2%	8%	8%
Average	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	13%	11%	5%	(1%)	13%	15%

Source: Edison Investment Research

Exhibit 45: UK company P/E and EV/EBITDA ratings



Source: Edison Investment Research

Sum-of-the-parts valuations

Exhibit 46: BAE Systems SOTP valuation

	2011 NOPAT	P/E	Value (£m)	Basis
EI&S	445	8.5	3,765	Average of L-3, LM & Raytheon
Land & Armaments	373	8.7	3,238	GD
Programmes & Suppport	517	8.9	4,580	Avg of US primes, Babcock, Raytheon, Finmec & Thales
International	370	9.8	3,639	Premium to Finmec, Raytheon, Thales & Babcock
HQ & other			(693)	Discounted at cost of capital
Net debt			(97)	Current estimate
Equity value			14,432	
Shares in issue (m)			3,320	
Implied fair value per share (p)			435	

Source: Edison Investment Research

Exhibit 47: Cobham SOTP valuation

	2011 NOPAT	P/E	Value (£m)	Basis
Avionics & Surveillance	66	13.6	899	Avg of Rockwell, Honeywell, prem to Thales
Defence Systems	138	12.3	1,707	Avg of L-3, Rockwell, Ultra
Mission Systems	54	11.0	588	Prem to BAE, Boeing
Aviation Services	26	8.9	230	Babcock
EV			3,425	
Net debt			(373)	Current estimate
Equity value			3,052	
Shares in issue (m)			1,150	
Implied fair value per share (p)			265	

Source: Edison Investment Research

Exhibit 48: Rolls-Royce SOTP valuation

	2011 NOPAT	P/E	Value (£m)	Basis
Civil Aerospace	388	13.5	5,228	Boeing, EADS, UTC, MTU & UK civil sector
Defence	220	11.3	2,478	US defence sector & premium to UK A&D sector
Marine	250	10.6	2,645	Industrial Engineers
Energy	45	10.6	475	Industrial Engineers
EV			10,826	
Ave net cash			915	Current estmate
Equity value			11,741	
Shares in issue (m)			1,848	
Implied fair value per share (p)			635	

Source: Edison Investment Research

Exhibit 49: Avon Rubber SOTP valuation

	2011 NOPAT	P/E	Value (£m)	Notes
Protection & Defence	5.6	7.9	45	20% Discount to A&D sector
Dairy	2.6	9.3	24	Skellerup
Net debt			(14)	Current estimate
Equity value			55	
Shares in issue (m)			29	
Implied fair value per share (p)			190	

Source: Edison Investment Research

Exhibit 50: Babcock SOTP valuation

	2011 NOPAT	P/E	Value (£m)	Basis
Marine	96	11.6	1,114	Prem to James Fisher
Defence	57	13.2	748	Prem to QinetiQ / Serco / Amec / Carillion / Balfour
Support Services	64	12.8	819	Prem to Amec / Balfour Beatty / Serco / Interserve
International	29	14.0	400	Caterpillar / Alstom / Amec
"Synergy Benefits"	20	12.9	252	Average of other divisions
EV			3,334	
Net debt			(817)	
Equity value			2,517	
Shares O/S (m)			365	
Implied fair value per share (p)			690	

Source: Edison Investment Research

Exhibit 51: Chemring SOTP valuation

	2011 NOPAT	P/E	Value (£m)	Notes
Countermeasures	50	12.1	609	World leader, high margin / growth / visibility. Prem to UK Defence.
Pyrotechnics	33	10.3	336	Strengthening mkt position, good growth, corp activity. Prem to UK Defence.
EOD	23	14.0	319	High growth division, good order book. Prem to UK Defence.
Munitions	31	9.3	291	Division most at risk of slowdown. UK Defence.
Net debt			(261)	Current estimate
Equity value			1,294	
Shares in issue (m)			35	
Implied fair value per share (p)			3655	

Source: Edison Investment Research

Exhibit 52: Cohort SOTP valuation

	2011 NOPAT	P/E	Value (£m)	Notes
SCS	0.5	3.9	2	Discount to QinetiQ
MASS	2.7	7.6	21	Average of QinetiQ and discount to Ultra and Cobham
SEA	2.8	6.9	19	Discount to QinetiQ and Ultra
Net debt			3	Current estimate
Equity value			45	
Shares in issue (m)			41	
Implied fair value per share (p)			110	

Source: Edison Investment Research

Exhibit 53: Hampson SOTP valuation

	2011 NOPAT	P/E	Value (£m)	Basis
Aerospace Components & St	3.7	8.6	32	10% discount to UK A&D
Composites & Transparencies	17.5	10.0	175	5% premium to UK A&D
Net debt			(82)	Current estimate
Equity value			124	
Shares in issue (m)			278	
Implied fair value per share (p)			45	

Source: Edison Investment Research

Exhibit 54: Meggitt SOTP valuation

	2011 NOPAT	P/E	Value (£m)	Basis
Aircraft Braking Systems	86	13.6	1,172	Goodrich
Control Systems	36	14.2	517	Goodrich. Esterline
Polymers & Composites	26	10.0	263	UK A&D
Sensing Systems	28	14.2	397	Goodrich, Esterline
Equipment Group	53	9.9	531	Prem to Cobham, Raytheon, Thales, Babcock
Net debt			(855)	Current estimate
Equity value			2,026	
Shares in issue (m)			688	
Implied fair value per share (p)			295	

Source: Edison Investment Research

Exhibit 55: QinetiQ SOTP valuation

	2011 NOPAT	P/E	Value (£m)	Basis
UK Services	49	10.5	520	BAE, Serco, Babccock, LM, Boeing, WS Atkins
US Services	52	10.8	560	LM, Boeing, GD, ManTech, Raytheon, CACI. Accenture, SRA
Global Products	12	12.3	150	Prem to LM, Boeing, GD, Raytheon, iRobot, ATK
EV			1,080	
Net debt			(457)	Current estimate
Equity value			623	
Shares in issue (m)			657	
Implied fair value per share (p)			95	

Source: Edison Investment Research

Exhibit 56: Ultra Electronics SOTP valuation

	2011 NOPAT	P/E	Value (£m)	Basis
Aircraft & Vehicle Systems	17	12.4	216	US peers + prem to Thales & BAE
Tactical & Sonar Systems	45	13.9	623	Premium to UK sector - higher growth communications
Information & Power Systems	22	13.1	282	Premium rating in line with US peers, Battlespace IT
Enterprise value			1,121	
Net debt			2	
Equity value			**1,123**	
Shares in issue (m)			69	
Implied fair value per share (p)			1,640	

Source: Edison Investment Research

Exhibit 57: Umeco SOTP valuation

	2011 NOPAT	P/E	£m	Basis
Supply Chain	11	10.0	109	UK 'Civil' Aerospace multiple
Structural Materials	6	13.3	84	Prem to UK A&D sector
Process Materials	8	12.8	101	Prem to UK A&D sector
EV			295	
Net debt			(80)	Current estimate
Equity value			**215**	
Shares in issue (m)			48	
Implied fair value per share (p)			445	

Source: Edison Investment Research

Company profiles

Avon Rubber

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
09/08	54.6	(2.2)	(3.4)	0.0	N/A	N/A
09/09	100.9	6.2	14.5	0.0	9.8	N/A
09/10e	105.2	7.7	18.3	0.0	7.8	N/A
09/11e	111.3	8.9	20.8	0.0	6.9	N/A

Note: *PBT and EPS are normalised, excluding intangible amortisation and exceptional items.

Investment summary: Protective markets

Avon's strategy is to use the predictable and cash generative revenues of the Dairy business to develop the longer-term growth potential within Protection & Defence (c 75% of current sales). This provides Avon with a stable revenue stream while offering potential for the group to double in size over the next decade. In addition, we feel that while this is a time for constraints in defence budgets, Avon's particular role in providing safety equipment that protects both military and first responders provides access to a robust market outlook.

Developing Protection & Defence

The core of the P&D division is now the US M50 gas mask. While this has an inherent growth profile, Avon has also developed its position in international markets, adjacent opportunities and growing aftermarket revenues. With a business that is now set up to address these opportunities and evidence of advances being made, we feel P&D will be the core driver of the group over the long term.

Financial progress for all to see

Progress was clearly demonstrated in May's interims and has carried on through Q3 as highlighted in the IMS. We feel Avon is now in a position to improve performance further, provide sustained growth and demonstrate that the strategy is working.

Sensitivities: Robust, long-term opportunities

The focus on growing P&D while improving performance in Dairy is the correct one in our view. With international opportunities developing and products to address adjacent markets such as homeland security, fire services and industrial applications opening up a much wider market opportunity, we feel Avon's future is looking bright. In addition, the completion of a new filter production line in the US providing access to sustained aftermarket revenues will increase the quality of earnings.

Valuation: Dwelling on the past?

The current rating of 6.9x FY11 EPS / 3.6x EV/EBITDA, a c 30% discount to the sector, remains rooted in past performance issues and concerns around wider defence budgets in our view. Even applying a 20% discount to P&D in our SOTP, to reflect the small cap stature of the group, achieves a fair value of 190p/share.

Price	142.5p*
Market Cap	£42m

** price as at 22 September*

Share price graph

Share details

Code	AVON
Listing	FULL
Sector	Aerospace & Defence
Shares in issue	29.14m

Price

52 week	High	Low
	142.5p	76.5p

Balance Sheet as at 30 September 2010*

Net debt/Equity (%)	29
NAV per share (p)	30
Net debt (£m)	14.7

** estimated*

Business

Avon Rubber designs, develops and manufactures products in the respiratory protection, defence and dairy sectors. Its major contract partners are national security and safety organisations such as the DoD and MoD.

Valuation

	2009	2010e	2011e
P/E relative	93%	73%	75%
P/CF	12.9x	4.4x	2.9x
EV/Sales	0.5x	0.5x	0.5x
ROE	188%	61%	42%

Revenues by geography

UK	Europe	US	Other
7%	6%	86%	1%

Analyst
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Exhibit 58: Avon Rubber divisional description

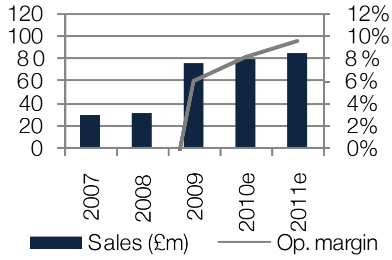
Operations	Performance

Protection & Defence

Avon's Protection & Defence division manufactures a range of respiratory protection products including gas masks, emergency hoods, self-contained breathing apparatus and powered breathing products. The business has two major US contracts to supply the M50 gas mask: a five-year order won in 2008 to provide 100,000 masks pa and a second 10-year option contract to provide up to 200,000 additional masks to 2013 and 300,000 masks pa to 2018. Despite losing out on a replacement mask competition to supply the UK MoD, for which Avon had been sole supplier since 1981, a steady flow of UK orders have remained while the new mask is being introduced. International opportunities are also delivered from the UK.

P&D has two main production locations, Melksham in the UK and Cadillac in the US. The UK facility manufactures the S10 and FM12 products and components for the US M50. The Cadillac facility produces the M50 and M53 products for the US, as well as filter production for which a new line is being introduced and this provides Avon with access to the long-term replacement market for the first time.

Outlook: With M50 production up and running and having inherent growth prospects, we feel that P&D will continue its expansion as evidenced in the Q3 IMS, with 20% year-on-year growth. In addition, with filter production due to start in 2011, international orders beginning to trickle through and potential new markets such as homeland security and industrial markets providing an increasingly balanced opportunity, we feel P&D will drive growth in the long term. While it is difficult to predict the timing of such inroads, we are confident that the portfolio effect will start to produce a more predictable growth profile.

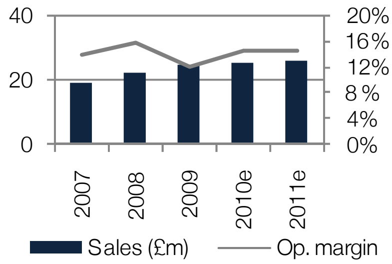


Dairy

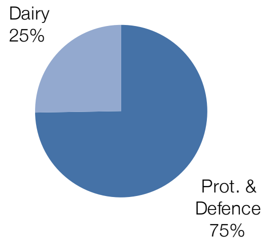
The Dairy business provides the consumable rubber liner that sits between a cow and the milking machine and associated rubber tubing. Avon supplies milk equipment manufacturers with own-label products and farmers directly through the Milk-Rite brand. Management estimates it has a c 70% market share in the US and 50% in Europe. While milk production volumes have the largest impact on sales of milk liners, the price also has an element in driving discretionary spend.

Avon outsourced European milk liner production from its Melksham facility to the Czech Republic in 2009 which caused a slight dip in margins during the move. The business is now benefitting from the cost savings associated with this decision while the US production remains in-house.

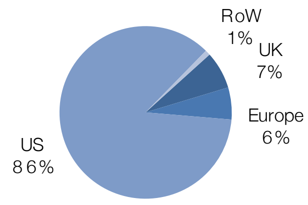
Outlook: The outlook for the milk market has remained fairly stable over the past five years and we do not anticipate any great change in this for the foreseeable future. As a result, Dairy provides a predictable revenue stream for Avon and, with the outsourced production now complete, further productivity gains should come through. In addition, Avon is looking to expand the range of milking products to benefit from the power of the Milk-Rite brand.



Divisional



Geographic



Source: Edison Investment Research

Exhibit 59: Financial summary

Year end 30 September	£'000s	2007	2008	2009	2010e	2011e
PROFIT & LOSS		IFRS	IFRS	IFRS	IFRS	IFRS
Revenue		48,666	54,606	100,900	105,201	111,301
Cost of Sales		(37,097)	(44,476)	(75,834)	(79,953)	(84,589)
Gross Profit		11,569	10,130	25,066	25,248	26,712
EBITDA (before amort. and except.)		3,871	(686)	9,660	12,810	14,629
Operating Profit (before amort. and except.)		934	(2,422)	7,294	9,985	11,419
Amortisation of Intangibles		(1,054)	(1,683)	(1,785)	(1,785)	(1,456)
Exceptionals		0	(8,481)	(2,535)	0	0
Other		0	0	0	0	0
Operating Profit		(120)	(12,586)	2,974	8,200	9,963
Net Interest		(801)	(988)	(1,506)	(1,314)	(1,364)
Other finance costs		2,489	1,183	394	(1,000)	(1,200)
Profit Before Tax (norm)		2,622	(2,227)	6,182	7,671	8,855
Profit Before Tax (FRS 3)		1,568	(12,391)	1,862	5,886	7,400
Tax		(717)	1,259	(2,004)	(2,355)	(2,812)
Discontinued operations		244	(8,337)	0	0	0
Profit After Tax (norm)		1,905	(968)	4,178	5,317	6,044
Profit After Tax (FRS 3)		1,095	(19,469)	(142)	3,532	4,588
Average Number of Shares Outstanding (m)		27.9	28.5	28.5	29.1	29.1
EPS - normalised (p)		6.8	(3.4)	14.5	18.3	20.8
EPS - FRS 3 (p)		3.9	(68.4)	(0.6)	12.1	15.8
DPS (p)		8.5	0.0	0.0	0.0	0.0
Gross Margin (%)		23.8%	18.6%	24.8%	24%	24%
EBITDA Margin (%)		8.0%	N/A	9.6%	12%	13%
Operating Margin (before amort. and except.) (%)		1.9%	N/A	7.2%	9%	10%
BALANCE SHEET						
Fixed Assets		54,060	68,704	30,384	32,297	31,638
Intangible Assets		17,305	9,549	9,936	9,098	8,644
Tangible Assets		20,041	15,491	20,177	22,928	22,723
Other		16,714	43,664	271	271	271
Current Assets		27,429	26,229	23,183	29,362	31,007
Stocks		11,526	10,134	9,528	12,582	13,312
Debtors		12,773	10,684	12,614	15,780	16,695
Cash		957	769	1,041	1,000	1,000
Assets held for sale		2,173	4,642	0	0	0
Current Liabilities		(28,015)	(32,650)	(31,566)	(35,479)	(32,927)
Creditors		(13,906)	(15,545)	(16,196)	(19,062)	(20,168)
Short term borrowings		(11,393)	(15,908)	(14,697)	(15,744)	(12,086)
Tax		(1,009)	(72)	(673)	(673)	(673)
Liabilities for assets held for sale		(1,707)	(1,125)	0	0	0
Long Term Liabilities		(10,018)	(19,616)	(19,737)	(17,487)	(15,237)
Long term borrowings		0	0	0	0	0
Deferred Tax		(6,251)	(13,289)	(2,104)	(2,104)	(2,104)
Retirement benefit obligations		(1,730)	(759)	(9,152)	(9,152)	(9,152)
Provisions		(2,037)	(5,568)	(6,649)	(4,399)	(2,149)
Other		0	0	(1,832)	(1,832)	(1,832)
Net Assets		43,456	42,667	2,264	8,693	14,480
CASH FLOW						
Operating Cash Flow		(3,131)	304	3,147	9,456	14,090
Net Interest		(782)	(919)	(1,549)	(1,314)	(1,364)
Tax		(438)	172	(282)	(1,750)	(2,812)
Capex		(2,874)	(1,368)	(2,684)	(5,576)	(3,005)
Acquisitions/disposals		(2,431)	951	5,964	387	(1,002)
Equity financing		1,441	17	0	0	0
Dividends		(2,353)	(1,367)	(283)	0	0
Net Cash Flow		(10,568)	(2,210)	4,313	1,203	5,907
Opening net (debt)/cash		(1,107)	(10,436)	(15,139)	(13,656)	(14,744)
Cash FX effect		(111)	14	188	0	0
Discountinued operations / relocation		1,237	(1,453)	0	(2,250)	(2,250)
Debt FX and Other		113	(1,054)	(3,018)	(41)	0
Closing net (debt)/cash		(10,436)	(15,139)	(13,656)	(14,744)	(11,086)

Source: Company accounts/Edison Investment Research

Edison investment research

Babcock International Group

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
03/09	1,902	121	41.6	14.4	13.2	2.6
03/10	1,896	146	51.2	17.6	10.7	3.2
03/11e	2,999	225	52.5	19.0	10.4	3.5
03/12e	3,502	296	63.2	22.0	8.7	4.0

Note: *PBT and EPS are normalised, excluding intangible amortisation and exceptional items.

Investment summary: Services for a new reality

With attention on the defence and comprehensive spending reviews we feel that Babcock is suffering, along with the wider government-focused support services sector, without gaining credit for being focused on a more resilient sector ripe with opportunities for outsourcing. In our view Babcock has greater room to manoeuvre than its peers now that the VT acquisition is complete and there is an opportunity to deliver greater synergies than planned if required. With activities across air, land and sea, the group can provide services in whichever area of defence receives priority and we feel that it is well placed to benefit from the drive to reduce costs.

Defence should be viewed differently

Despite the inevitable noise that will surround defence cuts, we feel that it will be difficult in practice to make wholesale cancellations or remove funding for activities such as training. Indeed, with a fighting force likely to shrink, greater emphasis will be put on industry to be involved and help deliver savings behind the front-line.

Financials sound with synergies to come

Our FY11 forecasts are for revenues of c £3bn, PBT of £225m and EPS of 52.5p. We forecast net debt of £817m at year end, giving net debt:EBITDA of c 2.6x. Given Babcock's track record of delivering synergies, we feel there is potential for the targeted £50m to increase, providing a counterweight to any declines due to cuts.

Sensitivities – what is at risk from budget cuts?

In total we estimate c £700m of revenues to be under pressure; however we believe Babcock will be able to maintain the vast majority. 1) Marine – aircraft carrier build and surface ship maintenance (c £100m revenues); 2) Defence – RN Flagship Training contract renewal (c £40m); 3) Support Services – Regional prime contracts, rail track renewal, nuclear decommissioning, education and training (c £400m); and 4) International – Africa power generation and plant equipment (c £160m).

Valuation: Dwelling on the downside?

The concerns around government spending cuts are clearly impacting the rating which is currently 9.0x CY11 EPS / 8.2x EV/EBITDA. We feel that the business is more robust than being given credit and our SOTP fair value is 690p/share.

Price	547.5p*
Market Cap	£1,962m

** price as at 22 September*

Share price graph

Share details

Code	BAB
Listing	FULL
Sector	Aerospace & Defence
Shares in issue	358.42m

Price

	High	Low
52 week	642.0p	492.8p

Balance Sheet as at 31 March 2011*

Net debt/Equity (%)	85.0
NAV per share (p)	291.0
Net borrowings (£m)	816.7

** estimated*

Business

Babcock is a primarily UK-based support service company with operations in Marine (34%), Defence (18%), Support Services (33%) and International (15%).

Valuation

	2010	2011e	2012e
P/E relative	124%	100%	113%
P/CF	8.3x	7.5x	10.1x
EV/Sales	0.9x	0.8x	0.9x
ROE	32%	129%	19%

Revenues by geography

UK	Europe	US	Other
80%	0%	11%	9%

Analyst
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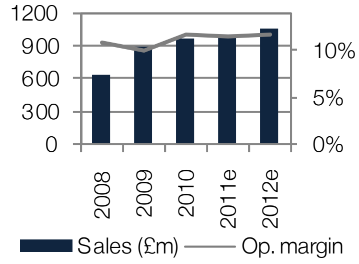
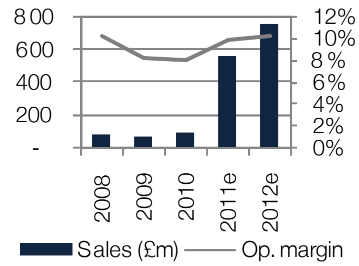
Exhibit 60: Babcock divisional description

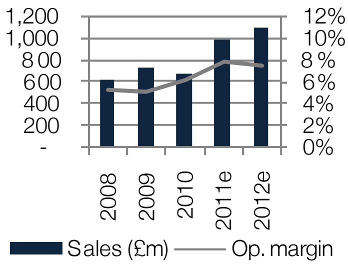
Operations	Performance
Marine	
The marine division encompasses Babcock's naval support business, with activities across base porting, refitting, refuelling and decommissioning submarines; maintaining and refitting warships; construction of the new aircraft carriers; managing naval bases; and providing equipment support on behalf of the UK MoD. This division predominantly contains Babcock's former Marine Services Division. The division comprises six business units that report into the divisional CEO, Archie Bethel. These units encompass: 1) Submarines – engineering support to the Royal Navy's (RN) submarine fleet at Clyde and Devonport; 2) Warships – maintenance and refit of the RN's surface ships. The unit is also assembling the Queen Elizabeth class aircraft carriers at Rosyth; 3&4) Naval bases – manages two of the three RN bases in the UK at Devonport and Clyde, responsible for a wide range of support activities; 5) Equipment Solutions – provides a wide range of logistics, supply chain and equipment management activities to the MoD including Fleet Wide Equipment. This unit also supplies the Jackal 2 and Coyote land vehicles currently used in Afghanistan; and 6) Integrated Technology – provides platform, system and product technology to both civil and military customers in the UK and overseas. The naval support activities in Canada and Australia report through this unit. Outlook: We view the Marine business as one which is likely to come under scrutiny following the defence review with questions raised about the Queen Elizabeth class aircraft carriers and the future size and shape of the Royal Navy. We believe however that the carriers will go ahead and that while the RN may see some cuts, the service is already overstretched to carry out its current activities. Interestingly, we actually see a number of opportunities within the division for further outsourcing of central MoD tasks such as wider equipment management following an expected slimming down of Defence Equipment & Support (DE&S) at the MoD. We will also be keeping an eye on the long-running debate regarding the number of naval bases in the UK.	
Defence and Security	
The defence & security division provides support services to all three Armed Forces delivering training services and asset support. The key in this area is a deep understanding of military ethos and a strong focus on customer relationships. The division brings together the military-focused support services of Babcock and VT. The division encompasses three business units, along with the Ascent Flying Training (MFTS) and Air Tanker Services joint ventures that report into the divisional CEO, John Davies. The units encompass: 1) Air – provides asset management, flight simulator maintenance and multi-activity airfield support services to the Royal Navy and Royal Air Force; 2) Training and Support – delivers large-scale, complex military training solutions as well as providing infrastructure support services and maintenance; and 3) Flagship – delivers VT Flagship operations including design, planning and assisting with the delivery and assessment of a range of training courses for the Royal Navy. Outlook: We anticipate that the SDSR will impact the division through various factors including the size and composition of the RAF and the associated knock-on effect on the multi-activity contracts, whitefleet management and future training needs. While we believe this could cause a weaker long-term outlook, we do not anticipate any sharp drop in activity in the near term, although there remains a risk that contract renewals may slip. We highlight the Royal Navy training through Flagship Training as a potential area that could be affected by the SDSR and the recomplete of the contract. We estimate this accounts for c £40m of revenue within defence & security and is due for renewal in 2011.	

Support Services

The support services division delivers a broad range of training and support services to a number of civil government and blue-chip customers, including government departments, police authorities, fire and rescue authorities, local authorities and international companies. The services include equipment support, infrastructure support, education & training, and communications. The division combines Babcock's former non-MoD support service activities with those of VT.

The division encompasses six business units that report to divisional CEO Kevin Thomas. These units comprise: 1) Waste – a developing energy from waste business that utilises the project management and process engineering skills of the business in conjunction with technology partners; 2) Critical Assets – delivers a broad range of capabilities across infrastructure and equipment support. The customer base includes organizations within the airport, communications, emergency services, networks markets; 3) Infrastructure – offers services in public and private estates, building and life cycle asset management; 4) Education and Training – the UK's largest integrated schools improvement service provider delivering services including careers advice and guidance, and educational IT. The unit is also the largest provider of work-based training; 5) Nuclear – nuclear engineering support services organization active in nuclear decommissioning, radioactive waste management, operations and maintenance to national and international customers; and 6) Rail – active in the UK rail infrastructure market and the largest conventional track renewal company in the UK.

Outlook: We believe that a number of areas in the support service division may well see lower growth and suffer potential delays. As a result, we anticipate that Babcock will be actively reviewing its position in these sectors to decide if further investment is warranted to create a leading proposition or whether an exit would be more appropriate. Of the constituent elements of the division, we feel that the main long-term focus is likely to be on critical assets, infrastructure, education & training and nuclear, with the nascent VT waste business likely to come under the microscope and the railway business an evergreen disposal candidate.

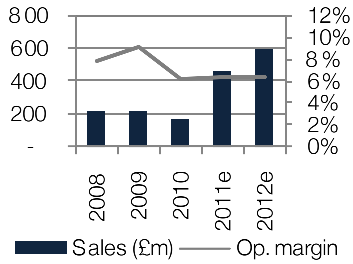


International

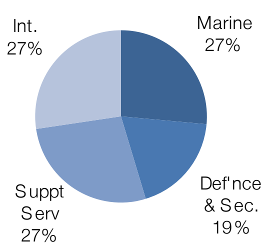
The international division encompasses a wide range of international activities from both Babcock and VT in the US, Africa and the Middle East. Activities vary depending on geography; however we view them as a springboard for the wider group to expand its presence and offerings into these markets.

There are three distinct markets served by the division, which all report directly to Babcock's CEO, Peter Rogers: 1) US – via VT Group Inc. Babcock provides support services to the US armed forces across design and implementation of specific training programmes, to maintenance and logistics support of key assets, including communication systems, facilities, vehicles and aircraft; 2) Africa – supplier of engineering support services to the energy, process, mining and construction industries in Africa including power generation and plant equipment; 3) Middle East – provides engineering support services knowledge to the Middle East, working through local partnerships. The unit has a presence in Oman and the UAE.

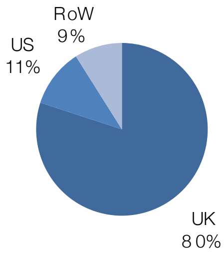
Outlook: We view the international markets as remaining resilient. We forecast the decline in Africa to have halted and the US business providing inherent growth for the division. However, we do note that signs of in-sourcing in the US have been reported elsewhere in the sector and we have factored this into our forecasts. We also factor in no contribution from the Middle East in the short term and believe this to be a bridgehead to identify further opportunities for the group. In our view the international division provides Babcock with a good long-term potential to offer its services in markets that are only starting to seek new ways of improving efficiency. We believe that this international angle was one of the compelling arguments for the acquisition and we feel that the combination of markets and services should generate significant long-term opportunities.



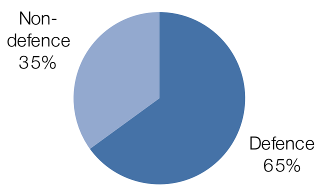
Divisional (pro-forma)



Geographic (pro-forma)



Customer (pro-forma)



Source: Edison Investment Research

Exhibit 61: Financial summary

£m	2008	2009	2010	2011e	2012e
Year end 31 March	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	1,555.9	1,901.9	1,895.5	2,998.6	3,502.0
Cost of Sales	n/a	n/a	n/a	n/a	n/a
Gross Profit	n/a	n/a	n/a	n/a	n/a
EBITDA	138.5	169.0	186.5	327.9	402.1
Operating Profit (before amort. and except.)	121.1	147.3	164.2	277.9	342.1
Intangible Amortisation	(10.9)	(14.2)	(16.1)	(60.0)	(60.0)
Exceptionals	0.0	0.0	0.0	(45.0)	0.0
Other	0.0	(0.2)	(0.5)	(0.5)	(0.5)
Operating Profit	110.2	132.9	147.6	172.4	281.6
Net Interest	(25.6)	(26.2)	(18.4)	(53.0)	(46.3)
Profit Before Tax (norm)	95.5	121.1	145.8	224.9	295.8
Profit Before Tax (FRS 3)	84.6	106.7	129.2	119.4	235.3
Tax	(14.9)	(19.1)	(20.8)	(47.1)	(62.1)
Profit After Tax (norm)	77.3	97.8	120.0	177.3	233.2
Profit After Tax (FRS 3)	69.7	87.6	108.4	72.3	173.2
Average Number of Shares Outstanding (m)	224.5	228.0	228.9	332.8	365.0
EPS - normalised (p)	33.4	41.9	51.4	52.7	63.3
EPS - normalised and fully diluted (p)	32.7	41.6	51.2	52.5	63.2
EPS - (IFRS) (p)	30.0	37.4	46.3	21.1	46.9
Dividend per share (p)	11.5	14.4	17.6	19.0	22.0
Gross Margin (%)	n/a	n/a	n/a	n/a	n/a
EBITDA Margin (%)	8.9	8.9	9.8	10.9	11.5
Operating Margin (before GW and except.) (%)	7.8	7.7	8.7	9.3	9.8
BALANCE SHEET					
Fixed Assets	836.1	858.4	877.4	2,169.4	2,081.4
Intangible Assets	542.5	603.9	628.5	568.5	508.5
Tangible Assets	293.2	241.0	234.6	1,586.6	1,558.6
Investments	0.4	13.5	14.3	14.3	14.3
Current Assets	621.2	559.3	607.7	667.7	717.7
Stocks	76.7	94.4	84.2	84.2	84.2
Debtors	340.9	335.7	330.9	390.9	440.9
Cash	199.6	123.6	189.6	189.6	189.6
Other	4.0	5.6	3.0	3.0	3.0
Current Liabilities	(639.8)	(676.6)	(696.6)	(703.7)	(715.8)
Creditors	(495.5)	(558.0)	(533.8)	(540.9)	(553.0)
Short term borrowings	(144.3)	(118.6)	(162.8)	(162.8)	(162.8)
Long Term Liabilities	(456.7)	(448.3)	(702.7)	(1,172.1)	(1,092.5)
Long term borrowings	(377.5)	(356.5)	(329.1)	(843.5)	(778.9)
Other long term liabilities	(79.2)	(91.8)	(373.6)	(328.6)	(313.6)
Net Assets	360.8	292.8	85.8	961.3	990.8
CASH FLOW					
Operating Cash Flow	119.2	153.6	170.3	225.9	249.6
Net Interest	(20.3)	(28.8)	(18.5)	(53.0)	(48.0)
Tax	(9.5)	(7.7)	(1.7)	(40.0)	(50.0)
Capex	(7.7)	(12.1)	(15.5)	(40.0)	(32.0)
Acquisitions/disposals	(385.1)	(98.5)	(41.1)	(1,362.0)	0.0
Financing	89.8	(7.3)	(1.9)	796.7	0.0
Dividends	(21.4)	(29.7)	(36.9)	(42.0)	(55.0)
Net Cash Flow	(235.0)	(30.5)	54.7	(514.4)	64.6
Opening net debt/(cash)	73.7	322.2	351.5	302.3	816.7
HP finance leases initiated	0.0	0.0	0.0	0.0	0.0
Other	(13.7)	1.2	(5.5)	0.0	(0.0)
Closing net debt/(cash)	322.4	351.5	302.3	816.7	752.1

Source: Company accounts/Edison Investment Research

BAE Systems

Year End	Revenue (£bn)	PBT* (£bn)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/08	18.5	1.8	37.1	14.5	9.0	4.3
12/09	22.0	2.0	40.1	16.0	8.3	4.8
12/10e	22.9	2.1	42.8	17.5	7.8	5.2
12/11e	23.1	2.2	45.4	18.5	7.3	5.6

Note: *PBT and EPS are normalised, excluding intangible amortisation and exceptional items.

Investment summary: Worldwide support

BAE Systems is the most international of all major defence companies, now operating in seven home markets. In addition, BAE's balance of activity across air, land and sea in both original equipment and support provides an inherent robustness, underestimated by investors. While not all of these markets will witness growth simultaneously, and indeed some areas will undoubtedly see cuts, we believe that the business is capable of delivering sustained growth over the short, medium and long term. The current rating appears to apply an arbitrary "UK defence cuts" mentality, without studying the true impact on BAE.

UK leader but a truly global operation

BAE is the largest supplier to the UK MoD, number four to the US DoD and has significant operations in Australia, Saudi Arabia, Sweden and South Africa. In addition, BAE also has an emerging presence in the key Indian market through the JV with Mahindra & Mahindra. Home markets accounted for 91% of H1 sales.

Financials

Interim results demonstrated that, despite lower activity in the land sector, the group was able to grow like-for-like sales by 7%, underlying operating profit by 14% and EPS by 14%. We forecast that the group will be able to maintain full year growth.

SDSR will impact – but how much?

We anticipate the SDSR will reprioritise programmes within the MoD. However, we highlight that the UK accounts for <30% of BAE's revenues with <20% derived from new build platforms, spread across aircraft, naval ships and submarines, and we estimate the largest individual programme, the Typhoon, accounts for a maximum of 7%. As a result, we believe that even if an entire programme were cut, the impact on BAE, while significant in UK terms, would not derail the rest of the business.

Valuation: Opportunity for the brave

The rating of 7.3x CY11 EPS / 4.6x EV/EBITDA positions BAE as one of the cheapest defence stocks in the UK, which we believe is unwarranted. We therefore view the current situation as providing investors who are prepared to see through noise surrounding defence cuts with an opportunity to build a good long-term position. Our SOTP valuation suggests a fair value of 435p.

Price	332.8p*
Market Cap	£11.3bn

** price as at 22 September*

Share price graph

Share details

Code	BAE
Listing	FULL
Sector	Aerospace & Defence
Shares in issue	3,407.57m

Price

	High	Low
52 week	388.8p	294.7p

Balance Sheet as at 31 December 2010*

Net Debt/Equity (%)	2.1
NAV per share (p)	141
Net borrowings (£m)	98

**estimated*

Business

BAE Systems is a global defence company with activities spanning production and support across air, land, sea and security markets. The group has operations in the UK, US, Kingdom of Saudi Arabia, Sweden, Australia and now India.

Valuation

	2009	2010e	2011e
P/E relative	78%	73%	80%
P/CF	5.5	6.4	5.9
EV/Sales	0.5	0.5	0.5
ROE	29%	32%	30%

Revenues by geography

UK	Europe	US	Other
30%	5%	51%	14%

Analysts

Roger Johnston 020 3077 5722

industrials@edisoninvestmentresearch.co.uk

Exhibit 62: BAE Systems divisional description

Operations	Performance

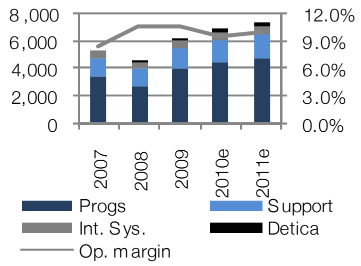
Programmes & Support

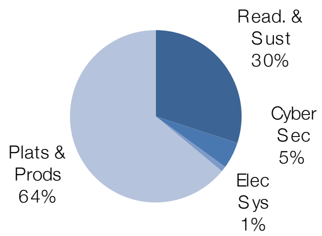
The Programmes & Support division primarily encompasses the group's UK-based air, naval and security activities and employs c 32,000 people. The division consists of Military Air Solutions, BAE Systems Surface Ships, Submarine Solutions, Detica and Integrated Systems and Technologies (Insyte). The activities comprise Platform & Products (c 64% of sales), Readiness & Sustainment (c 30%), Cyber and Security (c 5%) and Electronic Systems (c 1%).

The interim results demonstrated the benefits of the Saudi typhoon programme, good progress on the Type 45 Destroyer and activity on the Queen Elizabeth class aircraft carriers. This helped generate a like-for-like sales increase of 16% and although margins decreased slightly to 10.4%, this was as expected, with a net underlying margin increase largely as result of improved margins on the Nimrod and Astute contracts.

Outlook: The Programmes & Support division is the most likely to face budgetary pressures and will feel the greatest impact from the Strategic Defence & Security Review (SDSR). Given the embedded nature of BAE within the UK Defence industry, any cuts will have an impact within this division, however we view this as positive in the sense that both the government and BAE have a vested interest in ensuring an orderly rearrangement of programmes to reduce costs, while retaining capabilities and skills within UK industry. In the short term, BAE has already commenced restructuring in the Military Air business and this will hold back margins to some extent.

We also highlight the fact that we estimate no single programme in the UK accounts for >9% of group revenues in total, including OE and support. Hence we believe that the real impact on the group will be considerably less in financial terms than appears to be factored into consensus forecasts and valuations. Likewise, we believe that if cuts are made that reduce the UK's capability in one area, that should be counteracted to some extent by additional upgrades elsewhere, or an enhanced support solution on existing platforms.





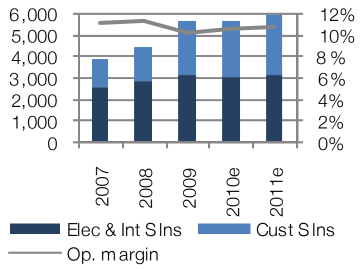
Electronics, Intelligence & Support

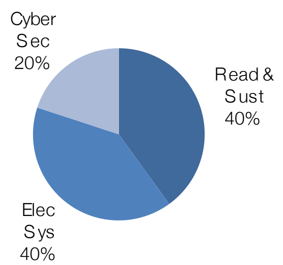
E,I&S provides a range of electronic systems and subsystems for military and commercial applications, technical and professional services for US national security and federal markets, and a growing ship repair and modernisation services activity. The division employs c 30,000 employees, predominantly in the US and sales are split between Electronic Systems (c 40%), Readiness & Sustainment (c 40%) and Cyber & Security (c 20%).

Interim results showed a like-for-like revenue decline of c 7% following contract delays as a result of the extended continuing resolution funding in the US at the end of 2009 and the slower-than-anticipated recovery from this. However, during the period there were a significant number of orders placed across the business that provide management with confidence that the full year will remain flat with organic growth resuming again in 2011. Despite the lower sales, margins were improved in the division following improved programme performance and guidance was upgraded from a range of 9-11% to 10-12%.

Outlook: In our view, the E,I&S business provides BAE Systems with access to the faster growth regions of defence budgets, namely electronic warfare (EW), infra-red, intelligence, surveillance and reconnaissance (ISR) and cyber security. We believe that these areas will allow BAE to regain above-average sales growth from 2011 onwards as orders work through to sales. Likewise, as the F-35 programme ramps up, BAE stands to benefit from its position as the provider of the Electronic Warfare suite and across the wider group with BAE providing 16% of the value content on the programme. This could also provide BAE with a supportive background to dispose of its Platform Solutions business for which there has long been a strategic intent as the business has moved away from subsystems and into prime contracts in the US. This could provide funds to expand the readiness & sustainment and cyber security activities in the US.

In addition, we feel that the growing ship repair business has the potential to leverage BAE's knowledge of through-life support to provide not just repair services, but a combined repair and upgrade approach as used in the UK. The recent acquisition of Atlantic Marine highlights to us the growing opportunity in this space and with supply chain efficiency at the top of the US agenda, we feel this approach may begin to get some focus, although we feel this will likely take several years before it become routine practice.





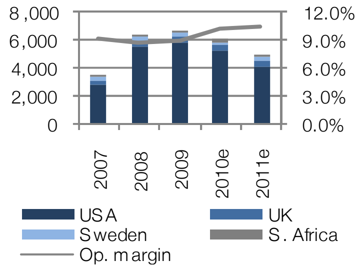
Land & Armaments

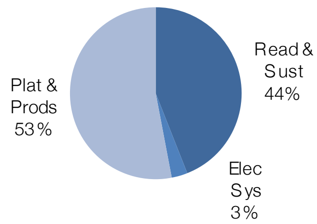
Land & Armaments is headquartered in the US and designs, develops, manufactures, supports and upgrades combat vehicles, tactical wheeled vehicles, naval guns, missile launchers, artillery systems, munitions and law enforcement products. The division employs c 18,500 employees in the US, UK, Sweden and South Africa with activities split between Platform & Products (c 53% sales), Readiness & Sustainment (c 44%) and Electronic Systems (c 3%).

Interim results were dominated by the impact of reduced volumes following the completion of the largest part of the MRAP programme and the beneficial impact of the quick and decisive action BAE undertook to realign the cost base to the forward load outlook. The net result of these was a reduction in like-for-like sales of 5%, better than previously anticipated, and a 220bps increase in margins to 10.3%.

Outlook: Land & Armaments will continue to come under top-line pressure following the loss of the follow-on FMTV contract and the current programme winds down in early 2011. Likewise, the pace of Bradley reset and upgrades are due to slow as the US focus has moved from Iraq to Afghanistan where the vehicles are not used. Guidance remains at a 30% decline in revenues over the next two years, however the better than expected performance in H1 suggests that this could be a bottom end scenario and we believe that revenues will hold up slightly better than the 30% level. In addition, we believe a number of new opportunities exist for BAE both in replacement programmes such as the Joint Light Tactical Vehicle (JLTV) and in upgrade opportunities that could provide upside to forecasts.

The benefits of BAE's swift actions to right-size the business with projected workload are due to continue in our view, as demonstrated in the interim results and we believe that it is this ability to improve the margins despite a significant reduction in revenues that provides us with confidence that once the FMTV contract has wound down, further progress can be made in the business as new programme opportunities are won.



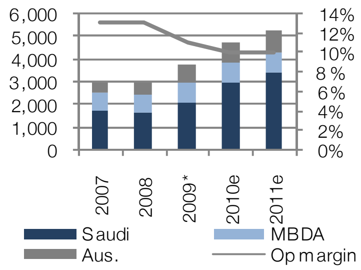


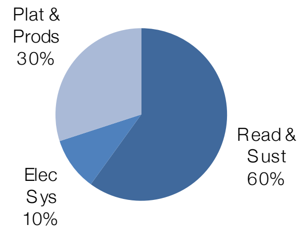
International

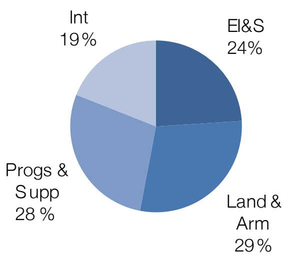
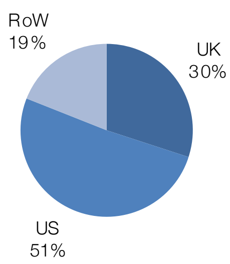
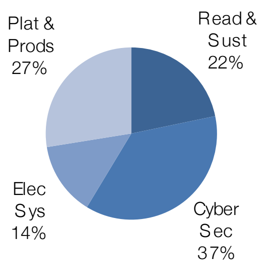
The International division is a collection of the group's non US/UK/land systems businesses and comprises the operations in Saudi Arabia, Australia, India and Oman, along with the group's 37.5% interest in the pan-European missiles business JV, MBDA. The group employs c 17,000 employees in these businesses with activities in Readiness & Sustainment (c 60% of sales), Platforms & Products (c 30%) and Electronic Systems (10%).

The division showed good progress at the interims with like-for-like sales increasing by 41% driven by Saudi Arabia with increased trading across the Saudi British Defence Cooperation Programme (SBDCP) and an increase in Australia on the back of progress on the Landing Helicopter Dock programme. Margins were consistent with the trend witnessed in H209 with lower margins traded on entry into service of Typhoons and the inherently lower margins at Tenix. Progress continued at MBDA and BAE developed its position in India with the formation of Defence Land Systems India Private Ltd, a JV with Mahindra & Mahindra to address land systems opportunities.

Outlook: The focus of the international business is about developing new home markets from which the group can participate in developing the customer's product base, but also gain a local industrial base in the market. This allows not only further opportunities to be addressed, but also allows BAE to provide a fuller service-based offering in the market that would otherwise be impossible. In the long term we view this approach to developing markets as providing significant shareholder value and continuing BAE's global evolution as a group.





Divisional	Geographic	Activity
		

Source: Edison Investment Research

Exhibit 63: Financial summary

£m	2007	2008	2009	2010e	2011e
Year end 31 December	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	15,758	18,543	21,990	22,929	23,119
Cost of Sales	n/a	n/a	n/a	n/a	n/a
Gross Profit	n/a	n/a	n/a	n/a	n/a
EBITDA	1,819	2,096	2,328	2,467	2,509
Operating Profit (before amort. and except.)	1,497	1,897	2,197	2,267	2,329
Intangible Amortisation	(149)	(247)	(286)	(300)	(300)
Exceptionals	(151)	61	(922)	(26)	0
Other	0	0	0	0	0
Operating Profit	1,197	1,711	989	1,941	2,029
Net Interest	(38)	(102)	(193)	(190)	(150)
Profit Before Tax (norm)	1,459	1,795	2,004	2,077	2,179
Profit Before Tax (FRS 3)	1,159	1,609	796	1,751	1,879
Tax	(335)	(640)	(350)	(602)	(653)
Profit After Tax (norm)	1,090	1,328	1,437	1,475	1,526
Profit After Tax (FRS 3)	824	969	446	1,149	1,226
Average Number of Shares Outstanding (m)	3,386.0	3,519.0	3,532.0	3,400.0	3,320.0
EPS - normalised (p)	31.6	37.1	40.1	42.8	45.4
EPS - normalised and fully diluted (p)	31.6	37.1	40.1	42.8	45.4
EPS - (IFRS) (p)	23.7	26.9	12.0	33.2	36.3
Dividend per share (p)	12.8	14.5	16.0	17.5	18.5
Gross Margin (%)	n/a	n/a	n/a	n/a	n/a
EBITDA Margin (%)	11.5	11.3	10.6	10.8	10.9
Operating Margin (before GW and except.) (%)	9.5	10.2	10.0	9.9	10.1
BALANCE SHEET					
Fixed Assets	13,170	17,606	16,619	16,338	16,023
Intangible Assets	9,559	12,306	11,253	11,065	10,735
Tangible Assets	1,774	2,446	2,552	2,552	2,702
Investments	1,837	2,854	2,814	2,721	2,586
Current Assets	7,090	8,069	8,788	8,638	8,838
Stocks	701	926	887	637	737
Debtors	2,769	3,628	3,725	3,825	3,925
Cash	3,226	2,827	3,943	3,943	3,943
Other	394	688	233	233	233
Current Liabilities	(9,524)	(10,790)	(11,993)	(11,483)	(11,226)
Creditors	(9,225)	(10,617)	(11,540)	(11,030)	(10,773)
Short term borrowings	(299)	(173)	(453)	(453)	(453)
Long Term Liabilities	(4,734)	(7,596)	(8,687)	(9,018)	(8,699)
Long term borrowings	(2,227)	(2,615)	(3,087)	(3,588)	(3,269)
Other long term liabilities	(2,507)	(4,981)	(5,600)	(5,430)	(5,430)
Net Assets	6,002	7,289	4,727	4,475	4,936
CASH FLOW					
Operating Cash Flow	2,182	2,009	2,232	1,801	1,909
Net Interest	12	(9)	(109)	(130)	40
Tax	(112)	(261)	(350)	(500)	(600)
Capex	(262)	(503)	(489)	(300)	(450)
Acquisitions/disposals	(2,112)	(1,038)	(254)	(162)	0
Financing	603	(27)	(20)	(500)	0
Dividends	(396)	(478)	(534)	(560)	(580)
Net Cash Flow	(85)	(307)	476	(351)	319
Opening net debt/(cash)	(435)	(700)	(39)	(403)	98
HP finance leases initiated	0	0	0	0	0
Other	350	(354)	(112)	(150)	0
Closing net debt/(cash)	(700)	(39)	(403)	98	(221)

Source: Company accounts/Edison Investment Research

Edison investment research

Chemring Group

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
10/08	354.2	74.2	159.2	35.0	18.6	1.2
10/09	503.9	102.6	212.1	43.0	14.0	1.4
10/10e	607.0	122.1	251.0	48.0	11.8	1.6
10/11e	797.0	149.6	303.4	56.0	9.8	1.9

Note: *PBT and EPS are normalised, excluding intangible amortisation and exceptional items.

Investment summary: Protecting budgets

We believe that Chemring is being unduly discounted due to concerns surrounding defence budgets and conflict-related revenues within the group. With a strategy to diversify revenues away from purely airborne countermeasures, we feel the group is in a good position to continue its growth trajectory and defy any macro-level budgetary declines. In the short term, performance has been driven by the ability to recover revenues from H1 caused by order delays, business relocation and issues at the UK facility, which we feel the group has confirmed within its IMS.

Resilience through the cuts

Chemring's business is built around delivering products that are inherently designed to protect the armed forces in one form or another. We believe this is true of the traditional countermeasures and flares and counter-IED products, right the way through to pyrotechnics used in aircrew ejection systems and battlefield training. As a result, we believe the end-market for Chemring's products will remain robust throughout the foreseeable future.

H2 weighting more extreme than usual

H1 results were affected by several factors including contracting delays and the timing of business relocation causing even greater H2 bias than usual. With delayed orders now received, we feel FY results are within Chemring's control and, given the group's track record of delivery, we feel comfortable our forecasts will be achieved.

Still viewed as a war stock?

Many investors still view Chemring as a pure war stock and that as hostilities in the Middle East wind down, revenues will simply plummet. We believe there are some counters to such an argument: timescales of withdrawal are difficult to predict; the group's balance between front-line and training; and acquisitions provide new opportunities (Mecar – non NATO and Roke – counterterrorism and electronics).

Valuation: Hit by budget concerns

The rating of 9.6x CY11 EPS / 6.4x EV/EBITDA is at the lower end of the historical range and reflects concerns regarding defence budgets. We believe the business will be much more immune than given credit and our SOTP suggests a fair value of 3,655p/share.

Price	2,967p*
Market Cap	£1,047m

** price as at 22 September*

Share price graph

Share details

Code	CHG
Listing	FULL
Sector	Aerospace & Defence
Shares in issue	35.29m

Price

52 week	High	Low
	3,663p	2,378p

Balance Sheet as at 31 October 2010*

Net debt/Equity (%)	91.9
NAV per share (p)	997.0
Net borrowings (£m)	302.2

**estimated*

Business

Chemring Group is a global leader in aircraft and naval countermeasures and other energetic materials for military use in training, peacekeeping and conflict. It has activities in the US, UK, Italy and Australia, primarily supplying home governments and NATO forces.

Valuation

	2009	2010e	2011e
P/E relative	132%	110%	106%
P/CF	9.8x	8.2x	6.6x
EV/Sales	2.3x	2.2x	1.6x
ROE	27%	27%	26%

Revenues by geography

UK	Europe	US	Other
25%	15%	47%	13%

Analyst

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Exhibit 64: Chemring Group divisional description

Operations	Performance

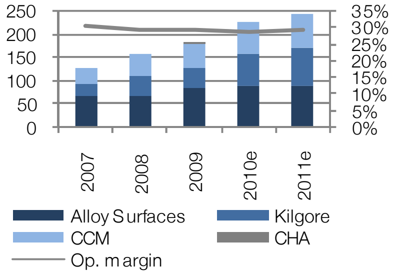
Countermeasures

Chemring's Countermeasures division encompasses operations in the UK and US and designs, develops and manufactures expendable countermeasures for air, land and sea platforms. Chemring has over 50% market share of the global countermeasures market and is the largest supplier to the UK MoD and US DoD. The division consists of four businesses: Chemring Countermeasures (UK); Alloy Surfaces (US); Kilgore Flares (US); and Chemring Australia (Aus).

Countermeasure's performance in H110 was mixed with revenues up 7% (10% in constant currency terms) driven by increases in US flare production but held back by slower UK production due to bad weather and a small incident that halted production during April. This also had a slight impact on divisional margins which fell by 100bps to 27% and as a result, operating profit remained flat.

Outlook: Our FY forecast includes a recovery in UK order intake as requirements are filled and the UK facility is anticipated to have recommenced spectral flare production during Q4 following April's incident. We also forecast continued strong growth in the US businesses on the back of good order intake that has seen the order book of Kilgore increase by over 121% since last year and further progress at Alloy. We forecast that this will support FY increases in production rates across these businesses and well into 2011.

Longer term we believe the Countermeasures market will continue to grow, with management predicting a plateau in 2011and a slight dip in 2012 due to the projected US defence budget squeeze. We believe, however, that with an increasing penetration in countermeasures dispensers on aircraft fleets, with particular growth in the need for helicopter protection highlighted by recent conflicts, the long-term story provides one of steady growth. In addition, the cost of advanced flares such as those on the F-22 and F-35 are several times those of current generation flares and hence even with lower volumes, in value terms growth can still be supported.



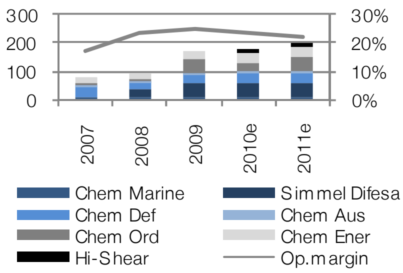
Energetics – Pyrotechnics

The Pyrotechnics division designs and manufactures a wide range of military and marine pyrotechnics such as smokes, flares, markers and battlefield simulation products. It also manufactures materials and subsystems for aircrew egress and space and satellite launch applications. The division consists of businesses in the UK, US and Australia.

H110 Pyrotechnics revenues were in line with 2009 despite several one-off factors across the business, with 25% lower production of illumination rounds at Simmel as production was matched to the UK's long-term requirements, no production of Battlefield Effects Simulators at Titan as manufacturing was transferred from Texas to Florida and Illinois, and an upgrade to the training grenade production line was undertaken in H1 with production due to restart in H2. As a result of the disruption this caused, in particular through the high operational gearing effect at Simmel, the margin decreased by nearly 300 bps to 19%.

Outlook: With both the signals & illumination and simulation & training streams having suffered delays and reductions in H1 and with a £40m UK MoD multi-year order received and the business relocations and upgrades in the US compete, we forecast a progressive turnaround in Pyrotechnics for H2. In addition, we anticipate that Hi-Shear will provide further stimulus to growth above the flat result in H1. We forecast the division will grow revenues by 2% and operating profits by 8%.

Longer term we see growth drivers across all three business streams with an increasing need for illumination products from both NATO and increasingly in the export market. Likewise we believe there will be further opportunities in simulation & training as concerns grow about soldier welfare and the need to ensure they are appropriately trained ahead of deployment in ever evolving scenarios requiring a continual refresh.



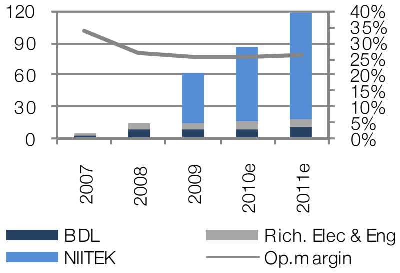
Energetics – Explosive Ordnance Disposal (EOD)

EOD is a relatively young business stream within Chemring, having been created initially following the acquisitions of BDL Systems and Richmond in 2006 and 2007 respectively. Since then, Chemring has significantly grown the business and completed the acquisition of Non-Intrusive Inspection Technology (NIITEK) in December 2008. This added vehicle-mounted IED detection systems to Chemring's stable of remote detector and neutralization devices.

The EOD performance in H110 was exceptional with revenue growth of 92% driven primarily by NIITEK where production of the Husky mine detection radar reached 10 systems per month. Margins were maintained at 24% and, as a result, operating profits doubled. Order intake up to the HY results declined by 30% due to delays in order releases, but these orders have now been placed including a follow-on contract for another 76 Husky Mounted Detection Systems (HMDS) worth an initial $106m and with potential to increase to $217m including spares, training and support.

Outlook: Through the NIITEK acquisition, Chemring was able to enter the counter-IED detection market with a nascent technology. Following an initial US Army order for 30 Husky Mounted Detection Systems received in early 2009, follow-on orders were gained for 50 and then 76 systems respectively with NIITEK now in contention for a much larger competitive tender for 600 systems which, when combined with spares and support could be worth as much as $1bn for the US Army alone. We feel that this acquisition, which cost just $22m in November 2008, demonstrates Chemring's ability to identify emerging market dynamics and appropriate acquisition opportunities.

We believe that EOD has one of the greatest growth profiles and the real potential for Chemring to make significant inroads into this formative market. With further investment in the neutralisation and detection business underway in the UK and development of handheld detection systems in trials, we feel there is developing momentum within the business.



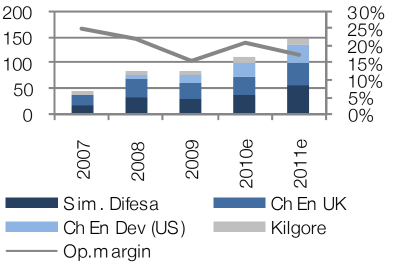
Energetics – Munitions

Chemring manufactures energetic sub-systems such as propellants and rocket motors, fuzes and primers as well as medium and large calibre ammunition and explosive components. The division operates in the UK, US, Norway and Italy and was bolstered by the acquisition of Hi-Shear Technology Corp in November 2009 which added further capability in electronic safety and arming and provided Chemring with a significantly enhanced position in the ballistic missile defence market, in particular on the Patriot (PAC-3) missile.

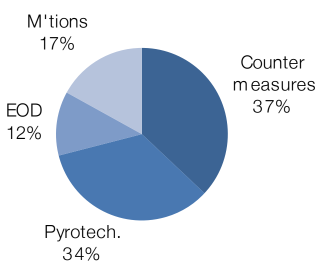
The Munitions division suffered a more subdued H1 2010 than the other divisions with revenues dropping slightly by c 5% but due to an improved operational performance, with margins raised to 20% (2009: 16%), operating profits increased by 27%. There were encouraging performances from Simmel and Chemring Australia and good sales growth to Middle East and Far East customers.

Outlook: We forecast that H2 revenues in munitions should pick up again with an order book increase of 20% supporting good cover for the FY. In addition, with Hi-Shear having received a $10m contract for Patriot fuses and the previous issues surrounding lead azide availability easing with the completion of Chemring's new primary manufacturing facility, there are a number of other emerging growth opportunities.

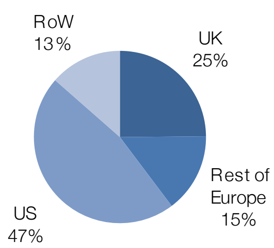
Longer term we view the munitions business as the most susceptible to budgetary pressures, particularly with a traditional large proportion of revenues from NATO. This is precisely the reason for the recently completed acquisition of the Mecar businesses from Allied Defense as these have >92% of the $140m of revenues outside the US and Europe. As a result, we believe that Chemring is yet again demonstrating its ability to identify pre-emptive measures where there is a risk of slowing revenue growth.



Divisional



Geographic



Source: Edison Investment Research

Exhibit 65: Financial summary

£m	2007	2008	2009	2010e	2011e
Year end 31 October	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	254.7	354.2	503.9	607.0	797.0
Cost of Sales	n/a	n/a	n/a	n/a	n/a
Gross Profit	n/a	n/a	n/a	n/a	n/a
EBITDA	68.0	94.6	128.0	156.1	189.1
Operating Profit (before amort. and except.)	61.2	84.9	114.7	142.1	174.6
Intangible Amortisation	(3.4)	(6.0)	(13.8)	(15.0)	(15.0)
Exceptionals	0.0	(10.5)	7.0	(9.2)	0.0
Other	(1.8)	0.0	0.0	0.0	0.0
Operating Profit	56.0	68.4	107.9	117.9	159.6
Net Interest	(8.1)	(10.7)	(12.1)	(20.0)	(25.0)
Profit Before Tax (norm)	53.1	74.2	102.6	122.1	149.6
Profit Before Tax (FRS 3)	47.9	57.7	95.8	97.9	134.6
Tax	(15.9)	(16.5)	(25.7)	(33.0)	(41.9)
Profit After Tax (norm)	36.1	54.1	75.0	89.1	107.7
Profit After Tax (FRS 3)	32.0	41.2	70.1	64.9	92.7
Average Number of Shares Outstanding (m)	32.3	33.8	35.3	35.4	35.4
EPS - normalised (p)	112.0	160.1	212.7	251.7	304.2
EPS - normalised and fully diluted (p)	110.8	159.2	212.1	251.0	303.4
EPS - (IFRS) (p)	99.3	121.9	198.8	183.3	261.9
Dividend per share (p)	25.0	35.0	43.0	48.0	56.0
Gross Margin (%)	n/a	n/a	n/a	n/a	n/a
EBITDA Margin (%)	26.7	26.7	25.4	25.7	23.7
Operating Margin (before GW and except.) (%)	24.0	24.0	22.8	23.4	21.9
BALANCE SHEET					
Fixed Assets	211.8	334.9	393.7	601.6	627.0
Intangible Assets	131.9	213.8	239.9	224.9	224.9
Tangible Assets	69.8	110.4	135.0	358.0	383.5
Investments	10.1	10.7	18.8	18.7	18.6
Current Assets	152.7	246.5	257.4	283.4	309.4
Stocks	51.2	89.1	96.9	121.9	146.9
Debtors	61.9	87.8	98.8	99.8	100.8
Cash	38.7	69.6	61.3	61.3	61.3
Other	0.9	0.0	0.4	0.4	0.4
Current Liabilities	(98.3)	(144.8)	(166.8)	(167.8)	(177.7)
Creditors	(75.1)	(124.4)	(132.0)	(133.0)	(142.9)
Short term borrowings	(23.2)	(20.4)	(34.8)	(34.8)	(34.8)
Long Term Liabilities	(142.2)	(206.0)	(210.7)	(386.2)	(336.0)
Long term borrowings	(115.0)	(165.8)	(149.2)	(326.7)	(276.5)
Other long term liabilities	(27.2)	(40.2)	(61.5)	(59.5)	(59.5)
Net Assets	124.0	230.6	273.6	331.0	422.7
CASH FLOW					
Operating Cash Flow	60.6	83.7	106.7	128.5	160.1
Net Interest	(7.4)	(8.2)	(10.5)	(17.0)	(20.0)
Tax	(12.0)	(13.4)	(18.7)	(32.0)	(32.0)
Capex	(14.4)	(31.0)	(33.4)	(50.0)	(40.0)
Acquisitions/disposals	(45.1)	(71.4)	(32.4)	(190.0)	0.0
Financing	(2.7)	55.7	(1.0)	(2.0)	0.0
Dividends	(6.0)	(9.3)	(13.8)	(16.0)	(18.0)
Net Cash Flow	(27.0)	6.1	(3.1)	(178.5)	50.1
Opening net debt/(cash)	70.6	99.5	116.6	122.7	300.2
HP finance leases initiated	0.0	0.0	0.0	0.0	0.0
Other	(1.9)	(23.2)	(3.0)	1.0	0.0
Closing net debt/(cash)	99.5	116.6	122.7	300.2	250.1

Source: Company accounts/Edison Investment Research

Cobham

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/08	1,467	244	15.4	5.0	15.3	2.1
12/09	1,880	295	18.7	5.5	12.6	2.3
12/10e	1,982	311	19.8	6.0	11.9	2.6
12/11e	2,108	338	21.6	6.6	10.9	2.8

Note: *PBT and EPS are normalised, excluding intangible amortisation and exceptional items.

Investment summary: Positioning for growth

Despite the slowing outlook for defence and nascent commercial recovery, we believe Cobham is positioned in many key areas that will survive restrained spending and maintain above-average growth. With the strategic review complete, the approach remains to develop advanced Tier 3 products for defence, security and commercial markets. While many will focus solely on the cost of the "excellence in delivery", programme, between £130-150m, Cobham is well placed to create a world-class operation to benefit shareholders over the medium term.

Better positioned than most, strategy to keep it that way

With 78% of Cobham's business related to defence and over 60% derived from the US, we feel that the business will remain resilient to slowing defence spend. In other areas growth is anticipated to be slower, offset to some extent by Cobham's dominant position. Where this is not the case, management has indicated active portfolio management relating to c 10-15% of technology divisions' revenues, the proceeds of which would be reinvested in building scale in higher growth markets through PV investment or acquisition.

Interims highlight delays, but signs of improvement

The interims demonstrated the impact of delays in the US procurement system, along with continued fragility in commercial markets, offsetting an increase in Aviation Services of 5%. With order intake up across the three technology divisions and sequential improvement between Q1 and Q2, we feel confident that revenues should increase modestly in H2. With the group trading margin increasing to 17.4% (H109: 17.0%), net finance expense essentially flat and a reduced tax rate of 26.5% (H109: 28.0%), EPS increased by 4% to 9.3p (H109: 9.0p). We forecast FY revenues of £2.0bn, PBT of £311m and EPS of 19.8p.

Valuation: Traditional premium lost, for now

The rating of 10.9x CY 11 EPS / 6.2x EV/EBITDA reflects concerns surrounding how achievable Cobham's medium-term revenue targets are, and the impact of the restructuring programme. We feel that once greater clarity is provided on the benefits, which we anticipate in November, the traditional premium Cobham enjoyed will re-emerge. Our SOTP valuation suggests a fair value of 265p/share.

Price	235p*
Market Cap	£2,712m

** price as at 22 September*

Share price graph

Share details

Code	COB
Listing	FULL
Sector	Aerospace & Defence
Shares in issue	1,154.2m

Price

52 week	High	Low
	275.9p	207.8p

Balance Sheet as at 31 December 2010*

Net debt/Equity (%)	28.8
NAV per share (p)	89.8
Net borrowings (£m)	248

**estimated*

Business

Cobham is an international aerospace & defence equipment supplier with businesses across avionics & surveillance, defence systems, mission systems and aviation services.

Valuation

	2009	2010e	2011e
P/E relative	119%	111%	119%
P/CF	7.2x	6.8x	6.4x
EV/Sales	1.6x	1.5x	1.4x
ROE	23%	22%	23%

Revenues by geography

UK	Europe	US	Other
9%	13%	60%	18%

Analyst
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Exhibit 66: Cobham divisional description

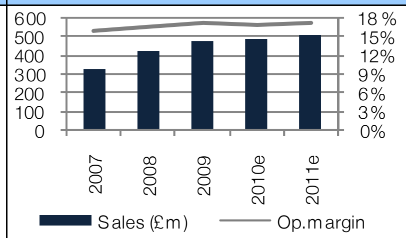
Operations	Performance

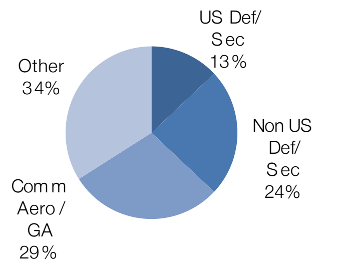
Avionics & Surveillance

The Avionics & Surveillance division designs, manufactures and supports a wide range of electronic products for air, sea, land and special purpose use. Operations are principally located in the US, UK, Canada, Denmark, France and South Africa and the division employs c 3,000 people. Revenues are split as follows: US Defence & Security – 13%; Non US Defence & Security – 24%; Commercial Aerospace / General Aviation – 29%; and Other – 34%.

H110 results were disappointing in Avionics & Surveillance with organic revenues declining by 5% held back ongoing fragility in commercial markets, particularly small aircraft and helicopters, and delays in awards of certain US contracts in the surveillance business. Divisional margins also decreased to 16.2% (H109: 16.7%) as a result of the lower commercial volumes offset to some extent by cost actions taken in areas such as procurement savings and the full benefits of the 2009 facility integrations.

Outlook: We view the Avionics and Surveillance division as the most closely linked to the commercial recovery. We also feel that the division houses a number of the products that appear less attractive as Cobham businesses and we would not be surprised to see some of these divested, particularly avionics equipment for small aircraft. Overall we feel that growth will be driven by areas such as SATCOM and surveillance equipment and less by avionics.



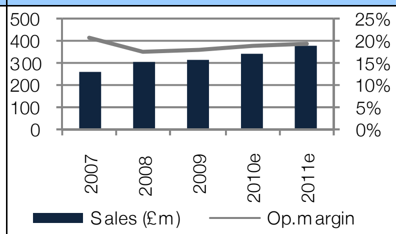


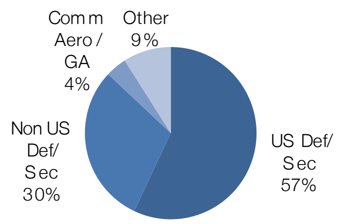
Mission Systems

Mission Systems contains the heritage of Cobham, in particular air-to-air refueling where the company is the market leader. The division also contains systems for weapons carriage and stores release across missiles, bombs and defensive aids. The final area the division is active in is personal survival and life support equipment. Operations are principally based in the UK and US and the division employs c 1,500 people. Revenues are derived from: US Defence & Security – 57%; Non US Defence & Security – 30%; Commercial Aerospace & General Aviation – 4%; and Other – 9%.

With performance at Mission Systems being driven by the delivery of delayed refueling pods and increasing deliveries of Eurofighter weapons carriage and release systems, the division generated good organic growth in H1. Total revenue was up 5% with organic growth of 7% partly offset by adverse currency translation effects. Margins improved to 17.0% (H109: 16.6%) benefitting from the combination of revenue growth and cost savings from the transfer and integration of product lines completed throughout 2009.

Outlook: Having had a slower 2009 due to delays in air refuelling, we anticipate growth to resume from 2010 onwards as these deliveries are made and further orders are received. We view this area as remaining attractive over the coming years as new refuelling programmes such as the US KC-X programme move through the procurement process. Likewise, Cobham's leading position in this area means that it is participating in a number of new areas such as UAVs that will provide opportunities over the long term.



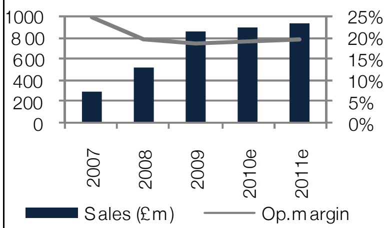


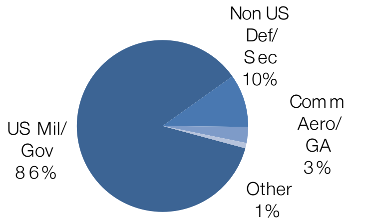
Defence Systems

The Defence Systems division designs, develops and manufactures critical technology for network centric and intelligence operations, enabling information to be moved and managed on the digital battlefield. The division also supplies high technology products for the commercial aerospace and civilian markets. Operations are principally located in the UK, US, Mexico, Sweden and Finland and the division employs c 5,300 people. Revenues are split: US Military & Government – 86%; Non US Defence & Security 10%; Commercial Aerospace & general Aviation – 3%; and Other – 1%.

Defence Systems' revenues in H1 decreased by 1% with organic growth of 2% offset by adverse currency translation effects. The division was impacted by delays in US military contracting, which held back organic growth, and missile defence contracts were slower to be let than had been expected, and various contracts were exited to avoid organisational conflicts of interest. However, good revenue growth was seen in passive microwave, composites and tactical communications products. Margins in the division benefited from improved currency transaction rates and ongoing cost saving and integration measures previously implemented.

Outlook: With contracts due to commence on the Cobham/Northrop Grumman vehicle intercom system (VIS-X) programme, a US$2.4bn 10-yr IDIQ due to commence over the next few years and current intercom systems also being supplied, we anticipate significant ongoing growth within Defence Systems. In addition, as contracts begin to free up in the US we anticipate new orders to be released across many of the areas that Cobham is active in across the C4ISR market, particularly in tactical communications.



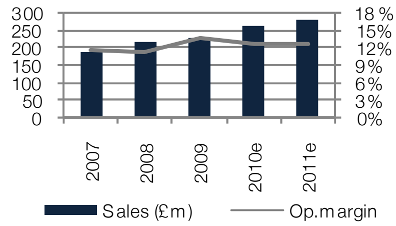


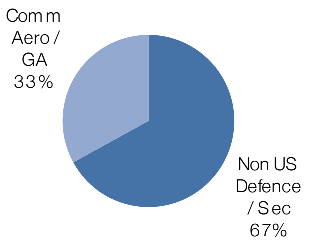
Aviation Services

Cobham Aviation Services operates more than 150 fixed and rotary wing aircraft around the world, operating the largest civil maritime surveillance contract in the world and training the UK's military helicopter pilots. In addition, the division provides air warfare training, flight inspection and conversion services at civil and military airports. The division operates principally in the UK, Australia and Germany and employs c 1,700 people. Divisional revenues are split between Non-US Defence & Security – 67% and Commercial Aerospace & General Aviation – 33%.

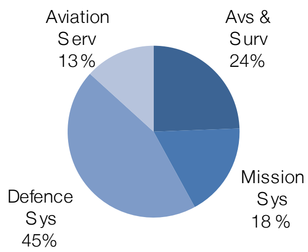
The H110 results showed strong revenue growth in Aviations service of 18%, benefitting from favourable currency translation and good organic growth of 5%. The organic growth was driven by increases in Australia from both the government Sentinel programme and in regional commercial services as the economy improved and outsourced aviation services returned to growth. In the UK, however, revenue was flat due to uncertainty surrounding the strategic review currently being undertaken. Divisional margins decreased to 12.0% (H109: 13.7%) as the prior year benefitted from several one-offs and greater large military aircraft maintenance revenues.

Outlook: We anticipate growth to remain good in Aviation Services throughout the remainder of 2010, driven particularly by the Australian recovery. In the UK we do not anticipate any significant growth until after the SDSR at which time we may well see some opportunities for further outsourcing of activities as the MoD looks to save money in services it provides, at which point further opportunities may become apparent in military training for example. Longer-term we question the full relevance of the Aviation Services business in Cobham's overall strategy.

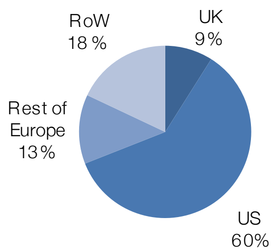




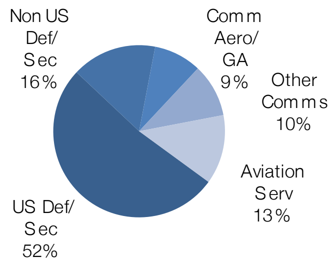
Divisional



Geographic



Customer



Source: Edison Investment Research

Exhibit 67: Financial summary

£m	2007	2008	2009	2010e	2011e
Year end 31 December	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	1,061	1,467	1,880	1,982	2,108
Cost of Sales	(717)	(1,009)	(1,284)	(1,350)	(1,450)
Gross Profit	344	458	596	632	658
EBITDA	249	283	389	423	453
Operating Profit (before amort. and except.)	199	252	337	358	388
Intangible Amortisation	(14)	(47)	(79)	(65)	(70)
Exceptionals	(19)	(76)	28	(51)	(60)
Other	0	0	0	0	0
Operating Profit	166	129	287	242	258
Net Interest	8	(8)	(42)	(47)	(50)
Profit Before Tax (norm)	207	244	295	311	338
Profit Before Tax (FRS 3)	174	121	245	195	208
Tax	(47)	(28)	(59)	(81)	(89)
Profit After Tax (norm)	149	176	215	230	250
Profit After Tax (FRS 3)	126	93	186	114	120
Average Number of Shares Outstanding (m)	1,134.0	1,137.8	1,142.4	1,153.0	1,153.0
EPS - normalised (p)	13.1	15.4	18.8	19.9	21.6
EPS - normalised and fully diluted (p)	13.0	15.4	18.7	19.8	21.6
EPS - (IFRS) (p)	11.1	8.1	16.3	9.8	10.4
Dividend per share (p)	4.5	5.0	5.5	6.0	6.6
Gross Margin (%)	32.4	31.2	31.7	31.9	31.2
EBITDA Margin (%)	23.5	19.3	20.7	21.3	21.5
Operating Margin (before GW and except.) (%)	18.7	17.2	17.9	18.0	18.4
BALANCE SHEET					
Fixed Assets	732	1,565	1,479	1,410	1,330
Intangible Assets	476	1,212	1,063	998	928
Tangible Assets	204	291	318	314	304
Investments	52	62	98	98	98
Current Assets	859	995	963	966	986
Stocks	170	247	250	255	265
Debtors	237	357	329	327	337
Cash	445	311	366	366	366
Other	8	80	18	18	18
Current Liabilities	(561)	(1,343)	(904)	(925)	(933)
Creditors	(318)	(519)	(501)	(522)	(531)
Short term borrowings	(243)	(824)	(403)	(403)	(403)
Long Term Liabilities	(226)	(368)	(590)	(417)	(286)
Long term borrowings	(124)	(128)	(376)	(212)	(81)
Other long term liabilities	(103)	(240)	(214)	(205)	(205)
Net Assets	804	849	948	1,035	1,097
CASH FLOW					
Operating Cash Flow	187	316	371	397	423
Net Interest	4	(6)	(46)	(40)	(50)
Tax	(23)	(58)	(31)	(60)	(80)
Capex	(43)	(55)	(85)	(63)	(86)
Acquisitions/disposals	(9)	(610)	(28)	(11)	(5)
Financing	5	4	6	10	0
Dividends	(44)	(53)	(58)	(68)	(72)
Net Cash Flow	77	(462)	129	165	130
Opening net debt/(cash)	(1)	(78)	641	413	248
HP finance leases initiated	0	0	0	0	0
Other	(0)	(257)	99	(0)	(0)
Closing net debt/(cash)	(78)	641	413	248	118

Source: Company accounts/Edison Investment Research

Cohort

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
04/09	76.7	5.8	12.2	1.8	5.3	2.8
04/10	78.1	4.0	8.1	2.1	8.0	3.3
04/11e	77.8	5.6	10.8	2.0	6.0	3.1
04/12e	79.8	6.1	11.6	2.0	5.6	3.1

Note: *PBT and EPS are normalised, excluding intangible amortisation and exceptional items.

Investment summary: UK focused dangers

We feel that Cohort is in a difficult position, with UK defence undergoing a period of uncertainty causing order delays and forthcoming budgetary cuts. Layered onto this is a business founded on a buy-and-build strategy that, through a lack of financial control, now finds it difficult to prosecute just that strategy and needs time to demonstrate it can deliver consistent results. However, we believe there are good parts to the business and if management can steer the group through the current difficult market unscathed, then the embedded value should become apparent.

A group of businesses or a business of groups?

With a strategy to consolidate small defence technology businesses, we feel there are currently too few synergies and further acquisitions would be required to make it work. While some benefits arise from access to a larger quoted parent, in our view many have been negated by the issues that hit the group in December 2009.

Financials hit by control issues

Revenue was largely flat at £78m with growth at MASS and SEA offset by a decline at SCS. Operating profit was down 34% to £4.1m, hit by the accounting irregularities at SCS and operational difficulties at SEA. Encouragingly, the order book increased to £112m, boosted by a £54m long-term MoD support contract. We forecast flat FY11 revenues with performance improvements generating a 32% increase in EPS.

Sensitivities – UK dominates, is it diverse enough?

With 73% of revenues derived from the UK MoD, we are concerned by the level of exposure given the forthcoming CSR and likely budgetary cuts. While management has indicated that 40% of its MoD revenue is not subject to spending constraints, that still leaves 60% likely to come under severe pressure. With a growing focus on export and non-defence opportunities across Space and Transportation there are signs of hope, but we feel that these too are likely to face budgetary pressures.

Valuation: Delivery key – credibility needs to be restored

If Cohort is to survive as a stand-alone entity then focus needs to be on delivering results. As such we feel the rating of 5.7x CY11 EPS / 2.9x EV/EBITDA reflects concerns surrounding both management control and market outlook. Our SOTP fair value of 110p/share highlights the potential upside if management can deliver.

Price	64.5p*
Market Cap	£26m

** price as at 22 September*

Share price graph

Share details

Code	CHRT
Listing	FULL
Sector	Aerospace & Defence
Shares in issue	40.79m

Price

52 week	High	Low
	167.0p	64.5p

Balance Sheet as at 30 April 2011*

Net debt/Equity (%)	N/A
NAV per share (p)	118.4
Net cash (£m)	5.2

**estimated*

Business

Cohort is a UK-based provider of services and products into the defence industry. The business operates through three divisions: SCS (34% of FY10 sales); Mass (27%); and SEA (39%).

Valuation

	2010	2011e	2012e
P/E relative	50%	74%	65%
P/CF	3.3x	5.9x	4.0x
EV/Sales	0.3x	0.3x	0.3x
ROE	11%	7%	9%

Revenues by geography

UK	Europe	US	Other
80%	15%	0%	5%

Analyst
Roger Johnston 020 3077 5722
industrials@edisoninvestmentresearch.co.uk

Exhibit 68: Cohort divisional description

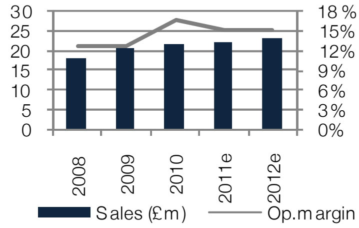
Operations	Performance

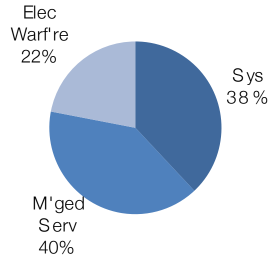
MASS Consultants Ltd (MASS)

The business was founded in 1983 and is based in St Neots, Cambridgeshire. It employs c 140 people and c 10 deployed associates. It has three business streams: 1) Systems – delivers secure systems, communications and other niche designs and solutions across both hardware and software; 2) Managed Services – mainly based on customer sites, delivers specific managed service provisions to the UK MoD; and 3) Electronic Warfare (EW) – delivers EW solutions, training and export operational support for Tornado.

2010 results demonstrated the continued progress of MASS with strong trading generating record figures for sales, profits, cash generation and order intake. Revenues increased by 4% to £21.4m, while trading profit increased by 25% to £3.5m with a good performance achieved across all three of its divisions.

Outlook: We view MASS as a high quality business within the Cohort portfolio and one that is positioned in areas we feel are likely to be more robust in the forthcoming budgetary cuts. In addition, following the acquisition of Abacus EW Consultancy in May for up to £2.8m, we view the outlook for the division as positive and, with long-term growth in prospect, the business has acquired larger premises adjacent to its existing facilities.



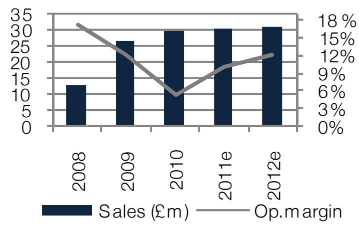


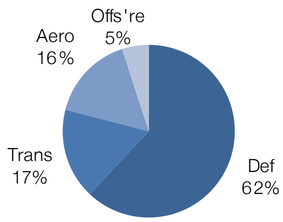
SEA

Cohort acquired SEA in October 2007 for £25m. The business was founded in 1988 and is based in Beckington, near Frome, Somerset. It has c 230 permanent employees. The division has three main business streams: 1) Defence – software and hardware for the UK MoD and other prime contractors on land, air and sea. Also acts as lead contractor on various research programmes for the MoD. 2) Transport – software and hardware solutions (based on sensors and strategic planning) to commercial customers including TfL, Network Rail and Highways Agency; and 3) Aero-Space – satellite sensors and bespoke systems for the European Space Agency and other prime contractors.

Despite an impressive 12% revenue growth in 2010, SEA's results were negatively impacted by problems at some of its projects, particularly a loss-making contract in the offshore sector as well as slower than anticipated order intake in the transport business. This saw the trading profit halve to £1.6m.

Outlook: Given a strong order book and good cover for 2011, we anticipate a modest improvement in sales with a greater impact coming from the restructuring effort towards the end of 2010 which saw rationalisation of business units to reduce costs and a refocusing of efforts on the defence sector. As a result, the poorly performing offshore business was subsumed into a newly created Marine division which also incorporated the maritime and underwater businesses. Longer-term, however, we feel SEA could be impacted by the forthcoming budgetary pressures.



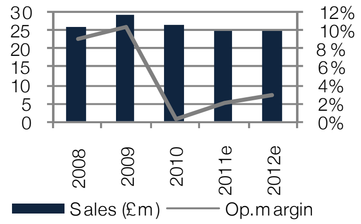


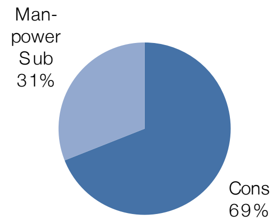
System Consultants Services Ltd (SCS)

SCS was set up in 1992 and was the original business placed into Cohort with the intention of making further acquisitions. The business is now based in Theale, Oxfordshire, and has c 100 permanent employees. Divisional revenues are split between: 1) **Consultancy** – provision of technical consultancy, advice and training primarily to UK MoD and prime contractors in Battlespace, Combat Systems Communication and other areas; and 2) **Manpower Substitution** – Provides former military and civilian personnel possessing key skills to UK MoD for temporary placements, using mainly associate staff.

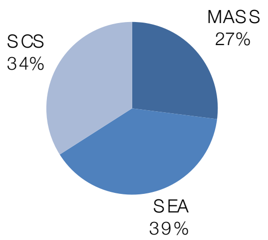
SCS suffered in 2010 following the discovery of significant accounting errors which had disguised deterioration in profitability caused by a combination of overhead cost increases, under-utilisation of core consulting staff, pricing pressure and new business taken on at insufficient margins. As a result, revenue fell by 32% and profits were down by 94%, barely making break-even. There were some areas of growth, particularly in logistics information systems and engineering support and the training support contract for the UK's Joint Permanent HQ was renewed, removing this risk.

Outlook: A significant restructuring was undertaken in SCS in Q4 2010 to reduce the cost base and right-size the business for current trading, reducing annual payroll costs by £2m. In addition, a new MD was appointed to run SCS from September 2010 with extensive experience in defence and consultancy sectors with Rockwell and Boeing. As a result, we feel that SCS is better-placed to deliver improved results than previously. However, we remain concerned that many of the areas that SCS targets will come under severe pressure and indeed while outsourcing may present an opportunity, cutting outside consultants will be a quick way for MoD to reduce costs.

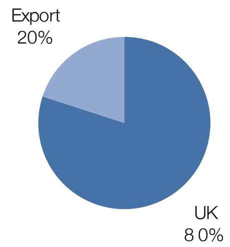




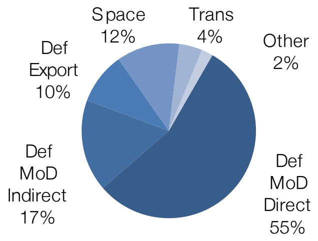
Divisional



Geographic



Customer



Source: Edison Investment Research

Exhibit 69: Financial summary

£m	2008	2009	2010	2011e	2012e
Year end 30 April	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	57.1	76.7	78.1	77.8	79.8
Cost of Sales	(40.4)	(54.0)	(56.7)	(57.0)	(58.0)
Gross Profit	16.7	22.7	21.5	20.8	21.8
EBITDA	6.5	6.6	4.7	6.4	7.5
Operating Profit (before amort. and except.)	6.0	6.0	4.1	5.8	6.9
Intangible Amortisation	(0.5)	(0.5)	(0.6)	(0.7)	(0.7)
Exceptionals	(0.0)	(0.7)	(0.6)	0.0	0.0
Other	(0.1)	(0.2)	0.0	0.0	0.0
Operating Profit	5.4	4.6	2.9	5.1	6.2
Net Interest	0.1	(0.2)	(0.1)	(0.3)	(0.8)
Profit Before Tax (norm)	6.1	5.8	4.0	5.6	6.1
Profit Before Tax (FRS 3)	5.5	4.4	2.7	4.9	5.4
Tax	(1.1)	(0.9)	(0.5)	(1.2)	(1.3)
Profit After Tax (norm)	5.0	5.0	3.3	4.4	4.8
Profit After Tax (FRS 3)	4.4	3.5	2.3	3.7	4.1
Average Number of Shares Outstanding (m)	35.0	40.5	40.7	40.9	41.2
EPS - normalised (p)	14.2	12.3	8.1	10.8	11.6
EPS - normalised and fully diluted (p)	14.1	12.2	8.1	10.8	11.6
EPS - (IFRS) (p)	12.5	8.7	5.6	9.0	9.9
Dividend per share (p)	1.5	1.8	2.1	2.0	2.0
Gross Margin (%)	29.3	29.6	27.5	26.7	27.3
EBITDA Margin (%)	11.3	8.6	6.0	8.3	9.4
Operating Margin (before GW and except.) (%)	10.5	7.9	5.3	7.5	8.6
BALANCE SHEET					
Fixed Assets	37.6	37.3	40.6	41.2	41.0
Intangible Assets	32.6	32.3	31.7	32.0	31.9
Tangible Assets	4.9	4.7	7.9	8.2	8.1
Investments	0.1	0.3	1.0	1.0	1.0
Current Assets	27.2	30.5	29.9	30.7	30.5
Stocks	1.0	0.4	0.4	0.7	1.0
Debtors	20.0	22.4	22.8	23.3	22.8
Cash	6.1	7.5	6.7	6.7	6.7
Other	0.1	0.2	0.0	0.0	0.0
Current Liabilities	(22.3)	(22.0)	(22.6)	(22.7)	(21.0)
Creditors	(19.1)	(18.8)	(19.4)	(19.6)	(17.9)
Short term borrowings	(3.1)	(3.2)	(3.2)	(3.2)	(3.2)
Long Term Liabilities	(1.7)	(1.5)	(1.7)	0.5	3.5
Long term borrowings	(0.8)	(0.6)	(0.4)	1.7	4.7
Other long term liabilities	(0.8)	(0.9)	(1.2)	(1.2)	(1.2)
Net Assets	40.8	44.3	46.4	49.7	54.0
CASH FLOW					
Operating Cash Flow	4.0	8.0	4.4	6.6	6.7
Net Interest	(0.1)	(0.2)	(0.1)	0.3	0.3
Tax	(0.5)	(0.4)	(0.3)	(2.0)	(2.0)
Capex	(0.5)	(0.4)	(3.8)	(0.9)	(0.5)
Acquisitions/disposals	(11.5)	(4.7)	(0.3)	(1.0)	(0.6)
Financing	7.1	0.2	0.2	0.0	0.0
Dividends	(0.4)	(0.6)	(0.8)	(0.9)	(0.9)
Net Cash Flow	(1.8)	1.8	(0.6)	2.1	3.0
Opening net debt/(cash)	(5.0)	(2.1)	(3.7)	(3.0)	(5.2)
HP finance leases initiated	0.0	0.0	0.0	0.0	0.0
Other	(1.1)	(0.2)	(0.1)	(0.0)	(0.0)
Closing net debt/(cash)	(2.1)	(3.7)	(3.0)	(5.2)	(8.2)

Source: Company accounts/Edison Investment Research

Hampson Industries

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
03/09	256.6	37.6	18.5	2.5	1.7	8.0
03/10	178.3	24.9	10.6	3.3	3.0	10.6
03/11e	170.4	12.9	3.4	0.0	9.2	N/A
03/12e	189.5	20.5	5.4	0.0	5.8	N/A

Note: *PBT and EPS are normalised, excluding intangible amortisation and exceptional items.

Investment summary: Surviving delays?

Hampson is in the difficult situation of having built a strong position in composite tooling through acquisition and investing in facilities to support predicted growth, while the very programmes that will drive that growth have been severely delayed. It therefore struggled with the level of debt and was forced to raise c £60m in February 2010. With further delays and a slower than anticipated recovery driving losses at Odyssey, Hampson is once again facing questions about its covenants.

Leader in composite tooling

Since 2004, Hampson has built up the leading player in the fragmented composite tooling market through acquisitions. This market is set to grow significantly once production of the B787 and A350 truly start and we believe that Hampson was unlucky with timing rather than strategic direction. The acquisitions, however, left the group over-exposed to the high debt levels and delays in this high value capital spend once the financial crisis hit and programmes moved to the right.

Financials hit by programme slippages

As a result of the delays in the 787, 747-8 and A350, Hampson's FY results suffered badly with revenues down 31%, trading profit down 32% and EPS down 43%. While management took action to cut costs, the profit warning in August highlighted that further actions were necessary.

Sensitivities: Focus back on covenants and orders

With Hampson's covenants relaxed to 4x net debt:EBITDA, reducing back down to 3x by March 2011, the group had bought some time for the market to recover. However, with management guiding HY trading profit of only £6m, focus has turned to how quickly the significant new orders recently received can be delivered. As such, we view the situation with cautious optimism.

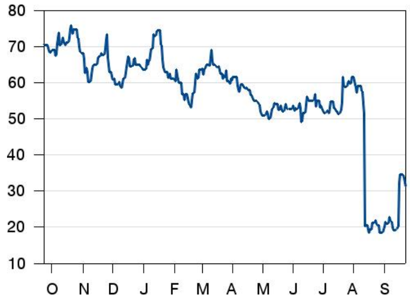
Valuation: Worries provide potential opportunity

The profit warning and return of concerns surrounding covenants has led to a severe de-rating of the shares to the current 6.4x CY11 EPS / 3.9x EV/EBITDA. We view Hampson as a high risk/high reward play with a good long-term opportunity to corner this emerging market, if the company survives the covenant tests with our SOTP suggesting fair value of 45p.

Price	31.3p*
Market Cap	£87m

** price as at 22 September*

Share price graph



Share details

Code	HAMP
Listing	FULL
Sector	Aerospace & Defence
Shares in issue	277.73m

Price

	High	Low
52 week	75.0p	18.3p

Balance Sheet as at 31 March 2011*

Net debt/Equity (%)	30.1
NAV per share (p)	164.6
Net borrowings (£m)	79.2

**estimated*

Business

Hampson Industries is the largest manufacturer of composite tooling and assembly systems for the global aerospace sector. The group also manufactures highly engineered components and assemblies for airframe and engine applications using advanced, lightweight materials.

Valuation

	2010	2011e	2012e
P/E relative	16%	28%	100%
P/CF	1.9x	2.2x	3.6x
EV/Sales	0.7x	0.8x	1.0x
ROE	12%	6%	3%

Revenues by geography

UK	Europe	US	Other
19%	10%	69%	2%

Analyst

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industrials@edisoninvestmentresearch.co.uk

Exhibit 70: Hampson Industries divisional description

Operations	Performance

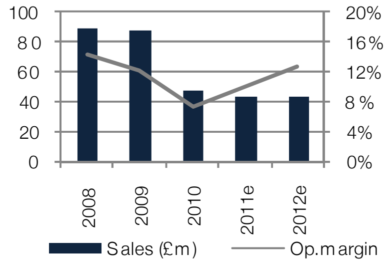
Aerospace Components & Structures

The group disposed of its non-core UK-based aerospace machining operations, HAML, for £23.8m in August 2009 to streamline the operations and focus on higher growth sectors. The division now operates from six facilities in the UK, North America and India and manufactures a broad range of metallic components for civil and military airframe structures. The group has a leading position in shims used during aircraft assembly.

2009 was a tough year for the division with revenues significantly down (-46%) as a result of the disposal of HAML, a loss of business at the group's UK aero structures facility and non-recurrence of Eclipse 500 revenue in the previous year. The lower demand was driven by supply chain rationalisation by Airbus and a sharp decline in business jet production.

Outlook: We view the Components & Structures business as being in a fairly poor position and although some of the more commoditised areas of the business have been disposed of, we feel the outlook is reasonably bleak in the short term. This is highlighted by yet further restructuring and cost reductions this year following a 30% reduction in headcount last. The one bright spot should be the shims business as production volumes pick back up again and now destocking has come to an end.

Longer term, Hampson has indicated that it is seeking to transfer its aero structures capability to India. We feel that this would help return the business to a competitive state. We also feel that this area of the business may well be one under review by the new CEO.



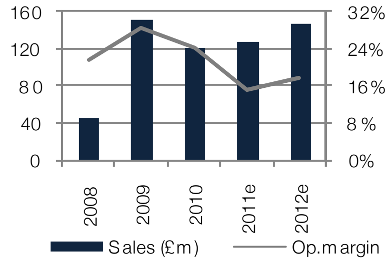
Composites & Transparencies

Operations consist of the design and fabrication of large, very close tolerance tooling systems for composite aero structures and satellite applications. The division also manufactures high performance anti-ballistic transparencies, molded thermoplastics, composite components for internal and external airframe structures as well as high temperature composite components for aero engines.

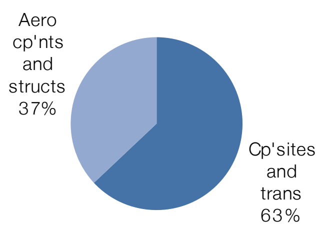
The division has been built up through acquisition, commencing with Texstars in 2004 and followed by CHI and Coast Composites in 2005, and Odyssey and GTS in 2008. This places Hampson as the leader in composite tooling in a highly fragmented, but increasingly important market.

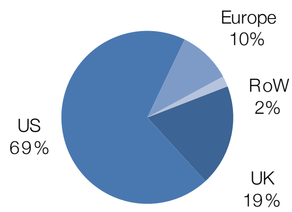
2009 was a challenging year for the division with revenues down 20% and trading profit down 32% with the delays to the 787 and 747-8 hitting Odyssey/GTS very hard, while Coast managed to weather the storm better. Headcount was reduced by 18% at Odyssey while a new management team was put in charge of the overall business. Elsewhere, CHI and Texstars won a number of important new programmes and should provide growth for the coming years.

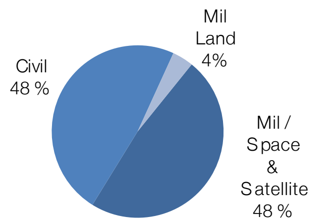
Outlook: We believe that this division is firmly where the future of the business lies due to the increasing proportion of composites being used within commercial and military aerospace. The leading position gives Hampson an opportunity to build further once programmes take off properly, and improvements across the business should be facilitated by the new management team.



Divisional	Geographic	Customer







Source: Edison Investment Research

Exhibit 71: Financial summary

£m	2008	2009	2010	2011e	2012e
Year end 31 March	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	157.9	256.6	178.3	170.4	189.5
Cost of Sales	n/a	n/a	n/a	n/a	n/a
Gross Profit	n/a	n/a	n/a	n/a	n/a
EBITDA	26.7	53.5	37.2	28.4	36.5
Operating Profit (before amort. and except.)	22.4	47.4	32.4	22.4	29.5
Intangible Amortisation	(0.7)	(6.8)	(3.0)	(6.0)	(6.0)
Exceptionals	(3.5)	(43.7)	3.9	(9.0)	0.0
Other	(3.7)	(2.5)	(2.8)	0.0	0.0
Operating Profit	14.5	(5.6)	30.4	7.4	23.5
Net Interest	(5.3)	(9.7)	(7.5)	(9.5)	(9.0)
Profit Before Tax (norm)	17.0	37.6	24.9	12.9	20.5
Profit Before Tax (FRS 3)	9.2	(15.4)	22.9	(2.1)	14.5
Tax	(2.3)	4.4	(6.1)	(3.5)	(5.6)
Profit After Tax (norm)	12.3	27.2	18.2	9.4	14.9
Profit After Tax (FRS 3)	6.8	(11.0)	16.8	(5.6)	8.9
Average Number of Shares Outstanding (m)	95.2	147.1	171.7	277.8	277.8
EPS - normalised (p)	13.0	18.5	10.6	3.4	5.4
EPS - normalised and fully diluted (p)	13.0	18.5	10.6	3.4	5.4
EPS - (IFRS) (p)	7.2	(7.5)	9.8	(2.0)	3.2
Dividend per share (p)	2.0	2.5	3.3	0.0	0.0
Gross Margin (%)	n/a	n/a	n/a	n/a	n/a
EBITDA Margin (%)	16.9	20.8	20.8	16.7	19.3
Operating Margin (before GW and except.) (%)	14.2	18.5	18.2	13.2	15.6
BALANCE SHEET					
Fixed Assets	124.1	382.4	357.0	351.2	346.7
Intangible Assets	83.3	327.3	305.5	299.5	293.5
Tangible Assets	40.8	48.8	48.4	48.6	50.1
Investments	0.0	6.2	3.1	3.1	3.1
Current Assets	86.9	125.9	86.8	72.8	67.9
Stocks	26.8	37.8	36.4	22.5	19.5
Debtors	36.1	63.6	33.5	33.5	31.5
Cash	21.8	18.8	16.9	16.9	16.9
Other	2.2	5.7	0.0	0.0	0.0
Current Liabilities	(43.4)	(107.5)	(58.5)	(49.0)	(43.6)
Creditors	(42.1)	(103.1)	(50.7)	(41.2)	(35.8)
Short term borrowings	(1.3)	(4.4)	(7.8)	(7.8)	(7.8)
Long Term Liabilities	(86.7)	(165.3)	(102.0)	(105.3)	(104.7)
Long term borrowings	(81.1)	(159.8)	(91.4)	(94.7)	(94.2)
Other long term liabilities	(5.6)	(5.5)	(10.6)	(10.6)	(10.6)
Net Assets	81.0	235.5	283.3	269.7	266.2
CASH FLOW					
Operating Cash Flow	20.6	23.8	24.6	24.4	30.5
Net Interest	(5.0)	(9.3)	(6.9)	(8.5)	(8.5)
Tax	(2.7)	(4.1)	5.4	(13.0)	(13.0)
Capex	(4.5)	(9.4)	(7.1)	(8.5)	(8.5)
Acquisitions/disposals	1.2	(136.8)	(1.2)	2.3	0.0
Financing	0.0	62.6	55.5	0.0	0.0
Dividends	(1.3)	(3.6)	(3.7)	0.0	0.0
Net Cash Flow	8.3	(76.9)	66.6	(3.3)	0.5
Opening net debt/(cash)	66.8	60.6	145.4	82.3	85.6
HP finance leases initiated	0.0	0.0	0.0	0.0	0.0
Other	(2.1)	(7.9)	(3.5)	0.0	0.0
Closing net debt/(cash)	60.6	145.4	82.3	85.6	85.1

Source: Company accounts/Edison Investment Research

Meggitt

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/08	1,163	243	26.4	8.5	11.1	2.9
12/09	1,151	234	25.3	8.5	11.6	2.9
12/10e	1,156	238	25.1	8.5	11.7	2.9
12/11e	1,213	265	28.2	10.5	10.4	3.6

Note: *PBT and EPS are normalised, excluding intangible amortisation and exceptional items.

Investment summary: Riding the recovery

Meggitt has demonstrated its ability to tough it out during the worst civil aviation downturn in living memory, while proving resilience that had previously been questioned. Management has also used the situation to accelerate a cost-reduction and transformation programme that has seen savings of £24m pa so far and a run-rate of £55m set for the end of 2010. With R&D maintained during the downturn and a number of new contracts that will support long-term revenues, we believe Meggitt is well positioned to benefit from the upturn.

Operations restructured and ready

Meggitt entered into a new transformation programme in 2008 to reduce costs, improve performance and position the group to be more competitive. With permanent activities including a reduction of management layers, supply chain sourcing initiatives and low-cost manufacturing in Mexico and China, we feel Meggitt is positioned to maintain its sector-beating margins over the long term.

Top line driven by civil decline, offset by cost reductions

The interims highlighted the balance in the group, generating a robust set of results with steady growth in military, despite order delays, held back by a decline in the group's civil businesses. Despite the resulting 6% decline in revenues, the cost reduction plan delivered a £24m run-rate of savings, enabling group margins to increase to 25.7% (2009 24.0%) and allowing operating profit to remain flat.

Sensitivities: Aftermarket key to resuming growth

In our view, the key to a resumption of growth is a return of the high margin civil aftermarket business, which accounts for 30% of revenues. With Meggitt's internal assumptions based on 1% air traffic growth, we feel there is room for upgrades with current traffic growth up 2.5% year-to-date. H2 should also see improved military revenues with orders now released in the US.

Valuation: Market recovery priced in?

Meggitt's rating recovered quickly once concerns over the debt position were removed in early 2009 and we now see 10.4x CY11 EPS / 7.1x EV/EBITDA as fair, given the improving market outlook and relative rating of nearest peer Goodrich. Our SOTP valuation suggests a fair value of 295p/share.

Price	293.5p*
Market Cap	£2,037m

** price as at 22 September*

Share price graph

Share details

Code	MGGT
Listing	FULL
Sector	Aerospace & Defence
Shares in issue	693.98m

Price

52 week	High	Low
	325.8p	224.9p

Balance Sheet as at 31 December 2010*

Net debt/Equity (%)	64.6
NAV per share (p)	182.8
Net borrowings (£m)	813

**estimated*

Business

Meggitt is a global manufacturer of aerospace equipment, sensing and defence systems. Its end markets are Civil Aerospace (43%), Military (43%) and Energy & Other (14%).

Valuation

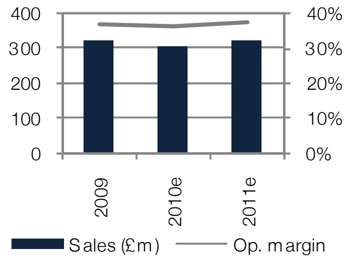
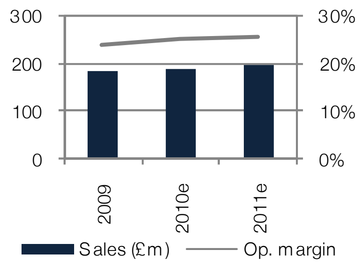
	2009	2010e	2011e
P/E relative	110%	109%	113%
P/CF	6.2x	6.4x	6.3x
EV/Sales	2.4x	2.5x	2.3x
ROE	13%	14%	13%

Revenues by geography

UK	Europe	US	Other
12%	23%	52%	13%

Analyst
Roger Johnston 020 3077 5722
industrials@edisoninvestmentresearch.co.uk

Exhibit 72: Meggitt divisional description

Operations	Performance
Aircraft Braking Systems	
Meggitt Aircraft Braking Systems (MABS) consists of a group of electro-mechanical engineering companies with a wide range of braking system products for use on commercial and military aircraft. These products encompass wheels, brakes and brake control systems and are characterised by high wear and tear leading to high aftermarket content. These systems are provided on over 30,000 in-service aircraft and the division targets sole source programmes. Aftermarket accounts for 87% of divisional revenues and 13% are derived from original equipment (OE). Production operations are located in the US, UK and Mexico as well as a repair station in Singapore. Interims were affected by the decline in civil aftermarket demand as air traffic declined and industry destocking took place. In addition many older aircraft, where aftermarket margins are greatest, were used to a much lesser extent than newer aircraft. Military revenues were also down, largely due to the completion of a substantial B1-B resupply contract in 2009. As a result, revenues declined by 11%, although swift cost reduction measures and the final integration benefits from the K&F acquisition helped increase operating margins from 36.0% to 37.5%, reducing the decline in profits to just 7%. **Outlook:** We forecast that FY revenues will decrease by 5% on 2009 as the recovery in civil aftermarket against weak comparators is offset by the lost comparative B1 revenues. We also anticipate the margins to remain at c 36% generating an 6% decrease in FY operating profits. Longer term we view the outlook for MABS as encouraging, with the large installed base generating substantial aftermarket revenues as the recovery in air travel demand requires increases in capacity. In addition, with new systems being developed such as the all-electric braking system for Bombardier's CSeries aircraft and increasing packages of work being won in aircraft such as the Irkut MC-21, we view longer-term sustainable growth as achievable.	
Control Systems	
Meggitt Control Systems (MCS) designs and manufactures products that either manage the flow of liquids and gases around turbine engines (aerospace & industrial) or control the temperature of oil, fuel and air around aircraft engines. Its valves business is also involved in the supply of airport ground fuelling products and it supplies cabin air conditioning for smaller aircraft. Aftermarket accounts for 46% of divisional revenues, with 54% derived from OE. Production operations are located in the US and UK with a repair station in Singapore. H110 revenues declined by 2% driven by reduced demand in general aviation for cabin air conditioning systems. The remaining civil, military and other segment revenues remained broadly flat and, as a result of the cost reduction programme, operating margins increased to 25.8% (2009: 23.3%), allowing operating profits to rise by 8% overall. **Outlook:** We forecast that FY revenues at MCS will improve in H2 as OEM revenues start to pick up again and aftermarket revenues increase. We also anticipate margins to remain healthy, above 25% generating a 7% increase in operating profits. We view MCS as a steady growth, long-term business that will recover once aircraft build rates increase again in 2011 and as the civil aftermarket returns to its traditional long-term rate of 5% pa.	

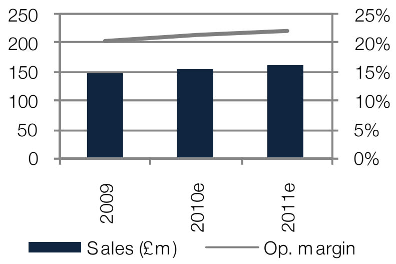
Polymers & Composites

Meggitt Polymers & Composites (MPC) supplies flexible bladder fuel tanks, ice protection products and composite assemblies for a range of fixed wing and rotorcraft platforms, as well as complex seals packages for civil and military platforms. Approximately two-thirds of revenues are military whilst aftermarket accounts for one-third of divisional revenues and two-thirds OE. Manufacturing operations are located in the UK and US.

Given the large proportion of military revenues, MPC was less affected by the civil slowdown in H1 2010 with revenues up 1% supported by continued growth in military sales offset to some extent by the weakness of the smaller civil contribution. Following the trends elsewhere in the group, operating margins rose to 20.7% from 17.8% on the back of cost reduction measures.

Outlook: We forecast MPC will continue to benefit from the resilient nature of its military revenues and the improved order outlook within the civil aftermarket witnessed towards the end of H1. As a result, we forecast a modest 5% increase in sales and, with margins remaining above 20%, we forecast an 11% increase in operating profits.

MPC has been successful in winning a significant number of recent contracts. This has included a break-through of the blast resistant fuel tanks onto US fighting vehicles with an initial $12m upgrade contract with the potential to develop into a much more significant contract across many thousands of vehicles. In addition, further contracts have been won on seals packages for the A350 XWB, potential Boeing offerings and long-term supply contracts for assemblies to AgustaWestland for the Lynx and AW101. These all go to support encouraging further progress at the division over the coming two to three years.



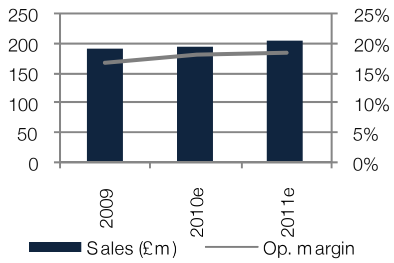
Sensing Systems

Meggitt Sensing Systems (MSS) provides high performance sensing and condition-monitoring solutions for high value rotating machinery and other assets. Sensing systems operates across the civil aerospace, military and energy industries, along with a broader medical, automotive and general industrial presence. The technology provides high performance sensing in extreme environments such as in aero-engines and industrial gas turbines. MSS generated 74% of revenues from OE and 26% from the aftermarket and the division has eight development and manufacturing operations in Switzerland, France, UK, Denmark and the US.

MSS saw a mixed performance in H110 with growth in civil and military revenues offset by declines in the other specialist markets, which continued to see weak demand. With revenues flat and the benefits of the group-wide cost reduction measures, operating margins increased to 18.4% (2009: 15.7%), increasing operating profits by 17%.

Outlook: We forecast MSS will to continue to benefit from good demand in civil and military while progress in other industrial markets will remain patchy. As a result, we forecast that revenues will improve with an increase of c 2% and margins remaining around 18% generating a 10% increase in operating profit.

We view MSS as having good long-term potential with the demand for energy increasing and as wider industrial markets enter a sustainable recovery pattern. With sensing systems also increasingly being embedded within aircraft, helicopters and engines to provide a more efficient, pre-emptive maintenance opportunity that allows cost-effective operation of assets, we see demand for sensing systems to be on the increase.



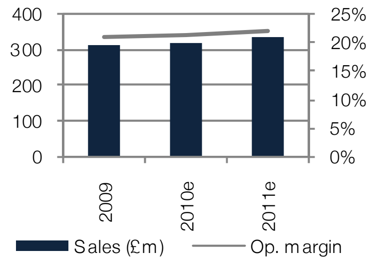
Equipment Group

Meggitt Equipment Group (MEG) brings together a range of businesses with differentiated capabilities and a specific focus including high speed electromechanical devices through to sophisticated electronics and electromechanical components and subsystems. This includes live-fire and simulation training, combat systems products for military aircraft and ground vehicles worldwide, fire protection, secondary flight displays, printed circuit heat exchangers (PCHEs) and industrial sensors. Two-thirds of revenues are generated from OE and one-third from aftermarket and operations are located in the UK, US, Canada and Spain.

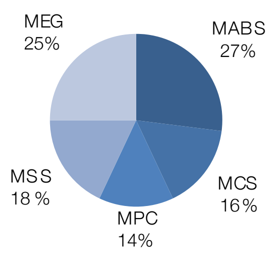
MEG revenues were down significantly in H110 by 11% following weak sales of PCHEs at the company's Heatric business and order delays in US for training while Overseas Contingency Operations (OCO) approval was delayed following the change in administration. Despite this revenue decline, operating margins were raised slightly to 20.9% (2009: 20.1%) through a combination of improved mix and cost reduction benefits.

Outlook: We view the issues in MEG during H1 as purely down to timing with order intake having improved and therefore we forecast a recovery in H2 that should see FY revenues broadly flat for the year. With the cost reduction benefits maintained and the improved mix we forecast margins to remain around 21%.

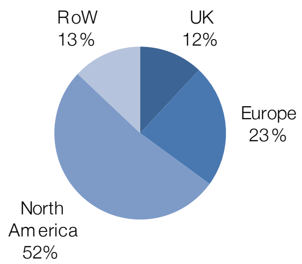
Longer term, we view MEG as a division that could well see some corporate activity in terms of acquisitions or disposal with many of the businesses contained therein not fitting into the traditional Meggitt model in our view. Although there are many individual growth opportunities we remain unconvinced as to the strategic rationale and benefits of MEG's diverse business structure.



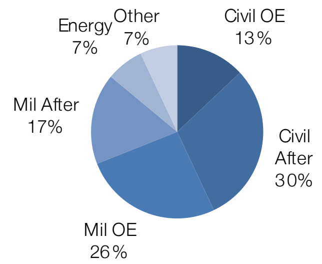
Divisional



Geographic



Customer



Source: Edison Investment Research

Exhibit 73: Financial summary

£m	2007	2008	2009	2010e	2011e
Year end 31 December	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	878	1,163	1,151	1,156	1,213
Cost of Sales	(493)	(638)	(656)	(655)	(680)
Gross Profit	385	525	494	501	533
EBITDA	235	341	340	326	352
Operating Profit (before amort. and except.)	216	296	286	290	314
Intangible Amortisation	(38)	(62)	(69)	(60)	(60)
Exceptionals	(74)	(124)	(53)	(72)	(60)
Other	0	0	0	0	0
Operating Profit	104	111	164	159	194
Net Interest	(37)	(53)	(52)	(52)	(49)
Profit Before Tax (norm)	179	243	234	238	265
Profit Before Tax (FRS 3)	67	58	112	107	145
Tax	(16)	(20)	(42)	(64)	(71)
Profit After Tax (norm)	130	175	171	174	195
Profit After Tax (FRS 3)	51	37	70	42	75
Average Number of Shares Outstanding (m)	586.9	661.9	676.4	687.8	687.8
EPS - normalised (p)	22.1	26.5	25.3	25.3	28.3
EPS - normalised and fully diluted (p)	22.0	26.4	25.3	25.1	28.2
EPS - (IFRS) (p)	8.7	5.6	10.3	6.1	10.8
Dividend per share (p)	8.2	8.5	8.5	8.5	10.5
Gross Margin (%)	43.8	45.1	43.0	43.3	44.0
EBITDA Margin (%)	26.8	29.3	29.6	28.2	29.0
Operating Margin (before GW and except.) (%)	24.6	25.5	24.9	25.1	25.9
BALANCE SHEET					
Fixed Assets	2,259	2,941	2,735	2,703	2,756
Intangible Assets	1,993	2,563	2,310	2,289	2,317
Tangible Assets	195	245	216	222	231
Investments	70	133	209	192	209
Current Assets	496	629	515	530	610
Stocks	205	273	237	257	317
Debtors	215	287	211	206	226
Cash	65	67	63	63	63
Other	11	2	5	5	5
Current Liabilities	(306)	(438)	(337)	(332)	(322)
Creditors	(289)	(423)	(327)	(321)	(312)
Short term borrowings	(17)	(15)	(11)	(11)	(11)
Long Term Liabilities	(1,385)	(1,846)	(1,639)	(1,644)	(1,591)
Long term borrowings	(865)	(1,101)	(861)	(865)	(812)
Other long term liabilities	(520)	(745)	(778)	(778)	(778)
Net Assets	1,063	1,286	1,274	1,258	1,453
CASH FLOW					
Operating Cash Flow	210	279	320	318	321
Net Interest	(30)	(46)	(42)	(42)	(40)
Tax	(23)	(30)	(39)	(60)	(60)
Capex	(84)	(100)	(84)	(107)	(108)
Acquisitions/disposals	(920)	11	(1)	0	0
Financing	430	2	1	4	0
Dividends	(36)	(40)	(30)	(52)	(60)
Net Cash Flow	(453)	75	126	61	53
Opening net debt/(cash)	354	815	1,048	809	813
HP finance leases initiated	0	0	0	0	0
Other	(9)	(308)	113	(65)	(0)
Closing net debt/(cash)	815	1,048	809	813	760

Source: Company accounts/Edison Investment Research

QinetiQ

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
03/09	1,617	130	15.9	4.8	6.9	4.4
03/10	1,625	86	11.1	1.6	9.8	1.5
03/11e	1,665	98	12.6	3.0	8.7	2.8
03/12e	1,738	114	14.5	5.0	7.5	4.6

Note: *PBT and EPS are normalised, excluding intangible amortisation and exceptional items.

Investment summary: Necessary restructuring

QinetiQ is entering a period of heavy restructuring in an attempt to refocus the business onto areas of growth and exit those without a future. With over half the business focused in the UK however, and the business still heavily populated by deep technical specialists, such changes would be painful and difficult to achieve at the best of times, yet alone when entering a period of defence budget cuts. We feel that further risks to forecasts remain a real danger and the timescale of proposed restructuring is too quick to be realistic in our view.

Programme is punchy in our view

CEO Leo Quinn joined in November 2009 and immediately conducted a strategic review to identify the issues that saw value destroyed since IPO. With forced growth and a supportive environment having masked weaknesses, the strategy is now to focus the business, transform the culture and strengthen the balance sheet to put it on a stronger footing. Whilst we agree these are the right things to do, we believe that the two-year timescale is simply unachievable in this environment.

Financials highlight difficulties

The 2010 results demonstrated the impact of the slowdown in letting of defence contracts, particularly in the US whilst the new administration bedded down and lower utilisation in the UK. This resulted in total revenues down 3% in organic, constant currency terms, operating profit down 21% and EPS down 30%.

Sensitivities – UK market a problem, what else?

44% of QinetiQ's revenues come from the UK and is underpinned to some extent by some good long-term contracts such as the LTPA. However, with MoD R&D in decline and now fully competitive, QinetiQ has seen a rapid fall in profitability and order delays have plagued the wider business. The US appears to have stabilised from last years' delays, however we anticipate margins to remain subdued.

Valuation: Where is the bottom?

The current rating of 7.8x CY11 EPS / 5.8x EV/EBITDA reflects the concerns around the market outlook and the restructuring and sees the shares hovering around all-time lows. We feel this is appropriate given forecast risk and indeed, our SOTP valuation suggests a fair value of 95p/share.

Price	108.9p*
Market Cap	£719m

** price as at 22 September*

Share price graph

Share details

Code	QQ.
Listing	FULL
Sector	Aerospace & Defence
Shares in issue	660.48m

Price

52 week	High	Low
	179.5p	105.0p

Balance Sheet as at 31 March 2011*

Net debt/Equity (%)

NAV per share (p)

Net borrowings (£m)

** estimated*

Business

QinetiQ Group provides technical advice, services and solutions to customers in the aerospace, defence and security markets, primarily in the UK and US.

Valuation

	2010	2011e	2012e
P/E relative	92%	81%	82%
P/CF	4.2x	5.4x	4.5x
EV/Sales	0.7x	0.7x	0.6x
ROE	15%	17%	17%

Revenues by geography

UK	Europe	US	Other
44%	1%	51%	4%

Analyst

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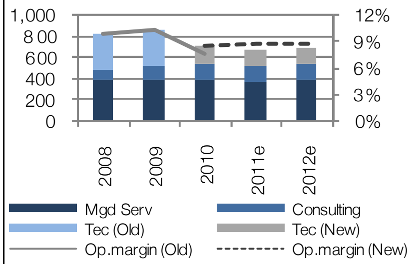
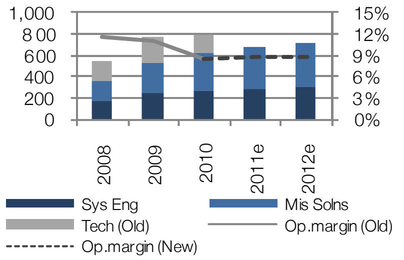
Exhibit 74: QinetiQ divisional description

Operations	Performance
EMEA / UK Services	
The EMEA division encompasses managed services in test & evaluation and aerospace including the MoD's 25-yr Long-Term Partnering Agreement and the much delayed DTR programme, buy-side technology and business advice, training delivery and QinetiQ's Australian businesses. The division also contains the technology solutions business which included those revenues associated with managed service tasks, pure MoD research and applied technology development. The latter two of these will move into the global products division as described below. FY10 results highlighted the impact of UK budget pressures and delays and resulted in a combination of much lower utilisation rates in Q4 than normal and did not see the traditional H2 pick-up in MoD revenues. Although revenues were only down 1% on an organic basis this masked the fact that there was a higher level of pass-through revenues which negatively impacted margins and hence operating profit declined by 27%. Outlook: We continue to remain cautious about the prospects of the UK business and we do not anticipate any rapid pick-up in orders as uncertainty prevails in the short-term until after the SDSR and associated budget cuts. Longer-term we also feel that further restructuring above the levels already announced may be required (391 positions announced in July 2010, 325 announced August 2010) if activity levels fail to improve. At the FY 2010 results it was announced that a new "simplified" structure will be adopted which will include UK Services, US Services and Global Products. EMEA will therefore cease to be reported and the new UK Services division will encompass all aspects bar c £125m of the Technology Solutions Businesses which will be transferred to Global Products. FY10 revenue would thus have been £694m, operating profit £59.1m with an operating margin of 8.4%.	
QinetiQ North America / US Services	
The QNA business was built up over the past five years through 15 acquisitions and encompasses the services business of Systems Engineering and Mission Solutions, along with the Technology Solutions business soon to be reported through Global Products. Revenues in 2010 were impacted by contracting delays in the technology business whilst the new administration settled in and decisions were taken about the surge strategy towards Afghanistan whilst services revenues increased by 7% organically. Outlook: We continue to view the US business as the better placed to deliver longer-term growth. However, it is likely to be held flat in the short term following insourcing of jobs within the US DoD. There have been strong orders in US technology for the new Q-NETS vehicle survivability product. We feel that due to increasing level of services revenues margins will remain at a lower than historic level overall. The new US Services division will include all QNA revenues except the c £173m of QNA Technology Solutions business which will move to Global Products. FY10 revenues would thus have been £628m, operating profit £52.6m with an operating margin of 8.3%.	

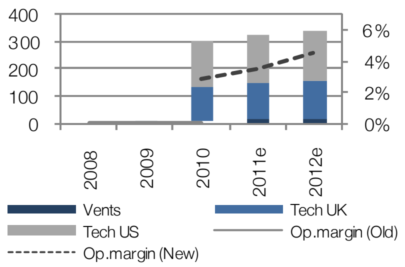
Ventures / Global Products

The Ventures portfolio contained three business in 2010: Tarsier (Foreign Object Detection); GPS Enabled Telematics (tracking solutions in difficult environments); and Optasense (acoustic sensing detection). The prior JV investment in Cody Gate Ventures Fund with Coller Capital, which included seven ventures businesses outside QinetiQ's core markets, was part disposed in March 2009 with the group now retaining a smaller 25% share in the venture.

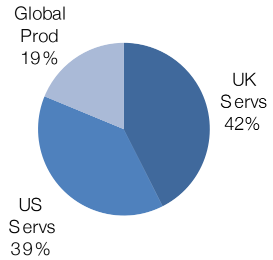
The 2010 results saw revenues of £6.5m and an operating loss of £8.5m with the prior year loss of £15.6m including £7.2m of equity accounted losses from Cody Gate Ventures that were not included in 2010 following the above mentioned disposal.

Outlook: We remain cautious about any significant leap forward in performance in the Ventures portfolio and indeed the visibility of such will be reduced following the creation of the Global Products division as described below. Whilst there will undoubtedly be some successes over the long-term from QinetiQ's dual-use research portfolio, we have always believed that this will not cause significant short-term outperformance.

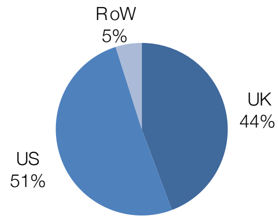
The new Global Products division will include all Ventures revenues plus the respective elements of the Technology Solutions businesses of the UK & US. FY10 revenues would thus have been £304m and operating profit £8.6m with an operating margin of 2.8%.



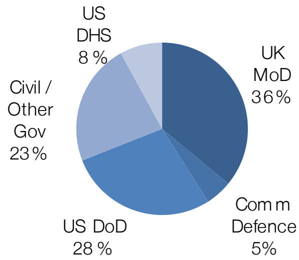
Divisional (new structure)



Geographic



Customer



Source: Edison Investment Research

Exhibit 75: Financial summary

£m	2008	2009	2010	2011e	2012e
Year end 31 March	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	1,366.0	1,617.3	1,625.4	1,665.1	1,738.4
Cost of Sales	n/a	n/a	n/a	n/a	n/a
Gross Profit	n/a	n/a	n/a	n/a	n/a
EBITDA	160.0	185.1	155.4	164.4	177.4
Operating Profit (before amort. and except.)	127.0	151.6	120.3	126.4	136.8
Intangible Amortisation	(18.0)	(23.5)	(26.1)	(27.0)	(27.0)
Exceptionals	(39.6)	7.3	(72.3)	(40.0)	0.0
Other	0.0	0.0	0.0	0.0	0.0
Operating Profit	69.4	135.4	21.9	59.4	109.8
Net Interest	(18.0)	(21.4)	(34.6)	(28.0)	(23.0)
Profit Before Tax (norm)	109.0	130.2	85.7	98.4	113.8
Profit Before Tax (FRS 3)	51.4	114.0	(12.7)	31.4	86.8
Tax	(4.0)	(20.4)	2.8	(15.3)	(18.2)
Profit After Tax (norm)	88.0	103.5	72.8	83.1	95.6
Profit After Tax (FRS 3)	47.4	93.6	(9.9)	16.1	68.6
Average Number of Shares Outstanding (m)	656.2	652.7	653.5	660.5	661.0
EPS - normalised (p)	13.4	15.9	11.1	12.6	14.5
EPS - normalised and fully diluted (p)	13.3	15.9	11.1	12.6	14.5
EPS - (IFRS) (p)	7.2	14.3	(1.5)	2.4	10.4
Dividend per share (p)	4.3	4.8	1.6	3.0	5.0
Gross Margin (%)	n/a	n/a	n/a	n/a	n/a
EBITDA Margin (%)	11.7	11.4	9.6	9.9	10.2
Operating Margin (before GW and except.) (%)	9.3	9.4	7.4	7.6	7.9
BALANCE SHEET					
Fixed Assets	918.2	1,163.1	1,051.3	1,037.0	1,014.4
Intangible Assets	546.5	802.7	721.4	705.1	678.1
Tangible Assets	332.4	332.4	285.5	287.5	291.9
Investments	39.3	28.0	44.4	44.4	44.4
Current Assets	563.9	877.4	582.7	592.7	612.7
Stocks	56.9	68.3	79.8	99.8	109.8
Debtors	472.1	535.3	431.2	421.2	431.2
Cash	24.5	262.1	63.9	63.9	63.9
Other	10.4	11.7	7.8	7.8	7.8
Current Liabilities	(418.0)	(473.6)	(428.9)	(439.2)	(432.4)
Creditors	(406.2)	(451.5)	(420.0)	(430.3)	(423.5)
Short term borrowings	(11.8)	(22.1)	(8.9)	(8.9)	(8.9)
Long Term Liabilities	(531.1)	(964.2)	(731.4)	(692.7)	(637.3)
Long term borrowings	(415.3)	(792.6)	(530.2)	(501.5)	(451.1)
Other long term liabilities	(115.8)	(171.6)	(201.2)	(191.2)	(186.2)
Net Assets	533	603	474	498	557
CASH FLOW					
Operating Cash Flow	138.3	175.2	169.2	132.4	158.4
Net Interest	(18.3)	(20.3)	(36.4)	(30.0)	(25.0)
Tax	(17.7)	(2.5)	1.5	(15.0)	(20.0)
Capex	(28.7)	(33.6)	(31.0)	(40.0)	(45.0)
Acquisitions/disposals	(116.0)	(74.1)	(25.6)	(10.7)	0.0
Financing	(12.8)	(0.8)	(0.8)	0.0	0.0
Dividends	(24.9)	(28.9)	(31.6)	(10.0)	(20.0)
Net Cash Flow	(80.1)	15.0	45.3	26.7	48.4
Opening net debt/(cash)	300.8	379.9	537.9	457.4	430.7
HP finance leases initiated	0.0	0.0	0.0	0.0	0.0
Other	1.0	(173.0)	35.2	(0.0)	0.0
Closing net debt/(cash)	379.9	537.9	457.4	430.7	382.3

Source: Company accounts/Edison Investment Research

Rolls-Royce

Year End	Revenue (£bn)	PBT* (£bn)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/08	9.1	0.9	36.7	14.3	15.7	2.5
12/09	10.1	0.9	39.2	15.0	14.7	2.6
12/10e	10.8	1.0	39.6	16.2	14.6	2.8
12/11e	11.5	1.1	44.4	17.5	13.0	3.0

Note: *PBT and EPS are normalised, excluding intangible amortisation and exceptional items.

Investment summary: Feeding the machine

In our view, the recession provided an opportunity for the quality, resilience and balance of the Rolls-Royce business to shine through with revenues rising through the worst civil downturn in living memory and growth maintained in all four divisions. The key to this is the long-running strategy that has seen investment in products and a focus on long-term services. With new programmes feeding the machine across the business, we expect this trend to continue and for Rolls' target to double the size of the business again in the next decade to be eminently achievable.

Demonstrable resilience during recession

Despite end markets having gone through unprecedented difficulties over the last two years, Rolls has consistently managed to produce top- and bottom-line growth. In addition, with the business now at a stage where cash generation is running at a level that more than covers the significant investment in capex, pension funding and tax, as well as increasing dividend payments, we view Rolls as being in a very strong position to continue its development over the long term.

Interims show signs of market recovery

2010 H1 results demonstrated the resilient nature, with the order book up 2%, revenues up 7% and underlying PBT up 4%, all supported by a £155m increase in average net cash and a 7% increase in the dividend. With encouraging signs that recovery is underway, we feel confident our FY forecast for 7% revenue growth and 7% PBT growth will be attained. With the tax rate increasing back to 25% following a lower 2009 charge, we forecast EPS to remain fairly constant y-o-y.

Sensitivities

There are several factors that could impact our forecasts: 1) currency – $18.8bn hedge book to provide increasing tailwind; 2) OE/Aftermarket split – greater OE would temper margins; and 3) operational improvements – investment to create a more flexible, global supply chain for both productivity and growth.

Valuation: The price of quality

The rating of 13.0x CY11 EPS, 6.2x EV/EBITDA, reflects that the business has proved its resilience. We feel this is a well deserved premium to the sector and Rolls provides a solid long-term investment. Our SOTP suggests a fair value of c 635p.

Price	576.5p*
Market Cap	£10.7bn

** price as at 22 September*

Share price graph

Share details

Code	RR.
Listing	FULL
Sector	Aerospace & Defence
Shares in issue	1,854.18m

Price

	High	Low
52 week	624p	430p

Balance Sheet as at 31 December 2010*

Net debt/Equity (%)	N/A
NAV per share (p)	232
Net cash (£m)	1,176

** estimated*

Business

Rolls-Royce is a global power systems business with activities in Civil Aerospace, Defence, Marine and Energy. The business supplies both original equipment (51%) and aftermarket services (49%).

Valuation

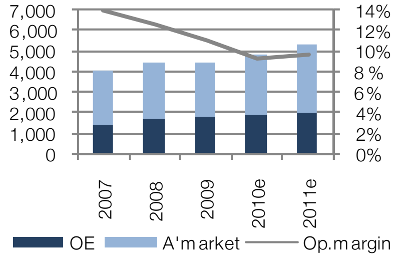
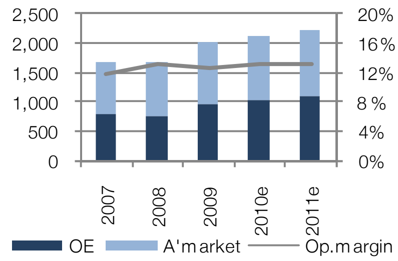
	2009	2010e	2011e
P/E relative	139%	136%	141%
P/CF	10.2	8.5	8.1
EV/Sales	0.9	0.9	0.8
ROE	19%	17%	16%

Revenues by geography

UK	Europe	US	Other
14%	22%	30%	34%

Analyst
Roger Johnston 020 3077 5722
industrials@edisoninvestmentresearch.co.uk

Exhibit 76: Rolls-Royce divisional description

Operations	Performance
Civil Aerospace	
Rolls-Royce's civil aerospace division is the most recognisable part of the business and its engines power a wide range of aircraft from general aviation through to large jets. The company has developed one of the broadest ranges of engines available in the market through a consistent strategy of technological development using a family concept for its engines. This is most typified by the Trent family of engines where there are over 1,700 engines in service and an order book of >2,300 across six aircraft programmes giving Rolls a 50% market share on modern widebody aircraft. Having built the installed base over many years, Rolls has developed its long-term service model through its TotalCare programme based on a "power by the hour" agreement. This removes some of the volatility associated with a more traditional time and materials service contract and allows the benefits of improved performance to be shared between Rolls-Royce and its customers. H110 deliveries of engines remained broadly stable on 2009, although mix effects towards more early-stage engines combined with a more sluggish time and materials aftermarket impacted margins which dropped from 11.3% to 9.2%. **Outlook** : With pressures on margins caused by deliveries of engines for new programmes, higher R&D charges and a lower than normal recovery in services revenues, we anticipate underlying profits to be modestly lower in 2010 than 2009. Given that many of these issues will still be present in 2011, we do not forecast a substantial improvement, however if the aftermarket returns, particularly the higher-margin time & material element, then we could well see upgrades to our forecasts in the outer years. Longer-term, we view the increasing proportion of revenues being derived from newer, larger engines (Trent/RB211: 62% of H110 H1 revs), driving the installed thrust higher and with a larger proportion of engines being delivered under TotalCare arrangements, we view the outlook as extremely healthy, providing long duration, cumulative revenue and profit streams.	
Defence Aerospace	
The Defence Aerospace division is one which we believe is well placed to weather any changes in defence spending due to a number of factors. Rolls' engines power a wide range of aircraft and helicopter types through a large installed base of over 18,000 engines across 160 customers in 103 countries. While much focus is inevitably directed towards combat aircraft engines such as the EJ200 for the Eurofighter and the alternate engine and Lift Fan for the JSF, we feel that the true strength in the portfolio lies within the breadth of the portfolio. With engines that power combat, trainers, helicopters, tactical and transport aircraft we feel that the resilience of the defence business is not fully appreciated. In addition, in recent years we have seen a move towards much greater levels of through-life support contracting that is more akin to the TotalCare approach in civil. This manifests itself in long-term service agreements and is a developing area we feel may well become more prevalent in defence as costs come under review and we have seen the UK contracting with Rolls to support engines on the Tornado and Eurofighter fleets. Indeed, 50% of divisional revenues are derived from services, 38% from OE and 12% from development contracts which again provides a resilience in our view. H110 saw good progress on development programmes across both the JSF LiftFan and F136 engine, as well as the TP400 engine for the A400M. Deliveries of engines grew in H1 with 373 delivered vs 284 in 2009 and this supported a 5% increase in revenues. This was particularly strong in the transport sector with growing deliveries for the C130-J and V-22 Osprey. With lower restructuring and R&D spend, improving operational performance and a more beneficial mix, margins increased to 15.5% (2009: 14.0%) driving a 16% increase in underlying profit. **Outlook**: We forecast that the FY revenues should be some 5% ahead of 2009 and while margins will be held back to some extent in H2 by the phasing of costs, we forecast that it will generate a c 10% improvement in underlying profits. Given the ongoing strength in the transport sector and the underlying service revenue stream, we believe that a similar level of growth should continue into 2011. Longer-term, we believe that given Rolls' dominant position in the UK defence sector, any changes to aircraft mix or usage will undoubtedly have an impact of that portion of the business. However, we estimate that approximately 20-25% of the business is related to the UK across both OE and aftermarket, so even if there was a slowdown in this area, the impact on the group as a whole would be manageable. Overall we feel that the breadth of both the portfolio and customer base provides an inherent resilience to the defence business and we would view any cancellations of programmes as an opportunity lost rather than a serious issue for the business.	

Marine

The Marine business provides integrated power systems for a range of applications in the offshore oil & gas (49% of H110 sales), specialist vessel (20%) and naval military (25%) and other (6%) markets. Its portfolio consists of ship design and ship systems spanning power systems, controls and instrumentation including main engines, propulsors, motion control stabilisers and steering gear. Rolls' main strength is its systems integration capability.

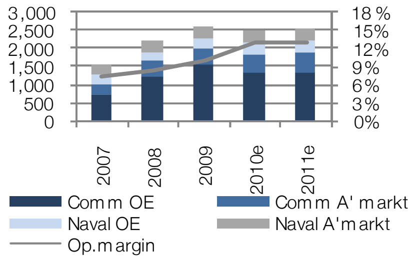
Rolls has product installed on >30,000 vessels with over 2,000 customers globally and this provides an emerging opportunity to provide services which is currently relatively small when compared to civil aerospace and defence at 32% of revenues. However, there are differences that make a service-based approach more difficult and there is a wider range of competition in that market. The key here is a global service centre network and we believe that this is a developing opportunity for Rolls to service not only its own systems, but also third party systems.

Marine performed extremely well during H110 with a double digit revenue growth and a 55% increase in profits despite what was inevitably a difficult trading environment. Cancellations, which were prevalent throughout 2009, have slowed and there is an early sign of demand recovery, however with £1bn of orders and £1.3bn of revenues, the backlog reduced slightly to £3.2bn. Importantly there were a number of new naval programme milestones that demonstrated the expanding portfolio including the US' Littoral Combat Ship (LCS) which entered active service. With down-select on this programme anticipated at the end of the year, this could see up to 50-60 vessels being ordered with additional export potential.

Services revenue across the business increased by 14% and due to the improving revenue mix, strong operational performance, more favourable contract pricing and the non-recurrence of c £40m of one-off charges in 2009, margins improved significantly to 12.6% (2009: 9.0%).

Outlook: Despite the completion of the acquisition of ODIM ASA in April adding c £200m of revenues in 2010, we forecast commercial OE revenues to be down in 2010. Given the developments in naval, we anticipate this to be up slightly on 2009 and we forecast services revenues to continue to grow. As a result, we forecast revenues to be down by c 5% overall but due to the improved mix between services and OE and the non-recurrence of the £40m one-offs in 2009, we forecast operating profit to be significantly ahead of 2009, up c 22%.

Long-term we anticipate further growth in services as the opportunity provided by the ODIM acquisition feeds through and the investment in service centres start to bear fruit. The recovery in commercial OE demand will be more difficult to predict and therefore we are relatively cautious in our assumptions in the outer years providing further upside potential once this market returns to growth.



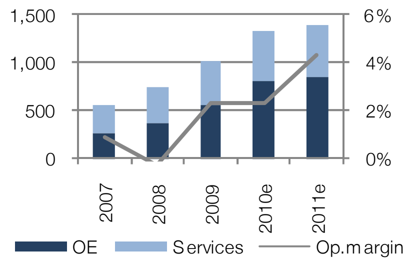
Energy

The Energy division is the smallest division within Rolls-Royce but is a growing opportunity for the business. It provides power systems for onshore and offshore oil & gas applications and also has a growing presence in the electric power generation sector and has customers in 120 countries. The portfolio consists of established 5-64MW aero-derived gas turbine energy solutions and emerging low-carbon developments including civil nuclear, tidal power and fuel cells.

The business has continued to make strong progress with a 47% increase in OE revenues in H110 and a double-digit increase in services leading to an overall increase in revenues of some 32%. Although there was an improved operational performance, this was offset by a £26m one-off charge relating to retrofit costs across the industrial Trent engines and this caused a £19m loss in the period. The backlog remained stable with £0.4bn of order intake in H1 and further opportunities are seen in the oil and gas sector.

Outlook: With a focus on operational improvement showing through in the results and further revenue growth anticipated in H2, we forecast that revenues will be up c 30% year on year in 2010 and despite the £26m retrofit costs, we forecast that profits will be up by a similar percentage. We anticipate this progress to be maintained in 2011 which will also benefit from no further retrofit costs, helping to almost double profits.

Longer-term we view the need for power to provide a sustained growth opportunity for the business. In addition, with Rolls' history of investment in technology, we believe that it is well placed to play a significant part in the supply chain of low-carbon technology at the appropriate stage.



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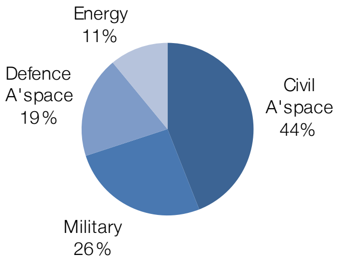
<td>
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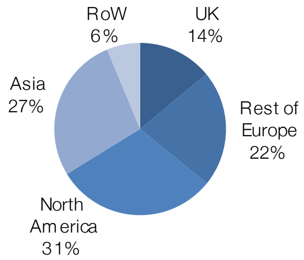
<td>
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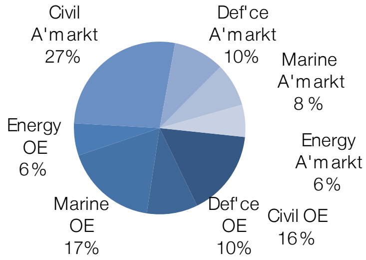
<td>
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Source: Edison Investment Research

Exhibit 77: Financial summary

£m	2007	2008	2009	2010e	2011e
Year end 31 December	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	7,817	9,147	10,108	10,813	11,462
Cost of Sales	(6,003)	(7,278)	(8,303)	(8,750)	(9,300)
Gross Profit	1,814	1,869	1,805	2,063	2,162
EBITDA	1,002	1,127	1,177	1,256	1,384
Operating Profit (before amort. and except.)	832	919	983	1,036	1,154
Intangible Amortisation	0	0	0	0	0
Exceptionals	(271)	(57)	189	0	0
Other	253	(2,715)	1,853	0	0
Operating Profit	814	(1,853)	3,025	1,036	1,154
Net Interest	(32)	(39)	(68)	(60)	(55)
Profit Before Tax (norm)	800	880	915	976	1,099
Profit Before Tax (FRS 3)	782	(1,892)	2,957	976	1,099
Tax	(133)	547	(740)	(244)	(275)
Profit After Tax (norm)	607	663	728	732	824
Profit After Tax (FRS 3)	649	(1,345)	2,217	732	824
Average Number of Shares Outstanding (m)	1,800.0	1,820.0	1,845.0	1,850.0	1,855.0
EPS - normalised (p)	34.1	36.7	39.7	39.6	44.4
EPS - normalised and fully diluted (p)	34.1	36.7	39.2	39.6	44.4
EPS - (IFRS) (p)	36.4	(73.6)	120.4	39.6	44.4
Dividend per share (p)	13.0	14.3	15.0	16.2	17.5
Gross Margin (%)	23.2	20.4	17.9	19.1	18.9
EBITDA Margin (%)	12.8	12.3	11.6	11.6	12.1
Operating Margin (before GW and except.) (%)	10.6	10.1	9.7	9.6	10.1
BALANCE SHEET					
Fixed Assets	4,206	6,302	6,048	6,569	6,879
Intangible Assets	1,761	2,286	2,472	2,772	2,992
Tangible Assets	1,813	1,995	2,009	2,276	2,366
Investments	632	2,021	1,567	1,521	1,521
Current Assets	7,253	9,046	9,374	9,326	9,777
Stocks	2,188	2,266	2,208	2,308	2,458
Debtors	2,592	3,929	3,877	3,927	3,977
Cash	1,952	2,806	3,188	2,990	3,241
Other	521	45	101	101	101
Current Liabilities	(4,754)	(6,439)	(6,312)	(6,262)	(6,031)
Creditors	(4,720)	(6,416)	(6,186)	(6,136)	(5,905)
Short term borrowings	(34)	(23)	(126)	(126)	(126)
Long Term Liabilities	(3,156)	(6,684)	(5,328)	(5,229)	(5,354)
Long term borrowings	(1,030)	(1,325)	(1,787)	(1,688)	(1,813)
Other long term liabilities	(2,126)	(5,359)	(3,541)	(3,541)	(3,541)
Net Assets	3,549	2,225	3,782	4,404	5,271
CASH FLOW					
Operating Cash Flow	1,029	1,161	1,046	1,261	1,314
Net Interest	(254)	(29)	(68)	(60)	(78)
Tax	(71)	(117)	(119)	(177)	(220)
Capex	(556)	(602)	(515)	(594)	(540)
Acquisitions/disposals	(16)	(46)	(91)	(161)	0
Financing	(111)	(31)	(2)	(58)	0
Dividends	0	(200)	(250)	(310)	(350)
Net Cash Flow	21	136	1	(99)	126
Opening net debt/(cash)	(826)	(888)	(1,458)	(1,275)	(1,176)
HP finance leases initiated	0	0	0	0	0
Other	41	434	(184)	0	0
Closing net debt/(cash)	(888)	(1,458)	(1,275)	(1,176)	(1,302)

Source: Company accounts/Edison Investment Research

Ultra Electronics

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/08	515.3	72.2	79.7	26.0	20.8	1.6
12/09	651.0	89.5	96.2	31.2	17.2	1.9
12/10e	713.6	98.8	102.8	34.5	16.1	2.1
12/11e	765.0	112.2	115.7	38.2	14.3	2.3

Note: *PBT and EPS are normalised, excluding intangible amortisation and exceptional items.

Investment summary: Steady growth assured

Ultra Electronics is a steady-growth business which has, since flotation in 1996, provided shareholders with a 17% CAGR in total shareholder return. This has been achieved through a business built up through both organic and acquisitive growth in niche areas of defence electronics across a broad range of customers. With no programme representing >5% of revenues, Ultra is immune to the fate of specific programmes, providing a highly visible and predictable revenue stream.

Strategy remains the same

Ultra's strategy has been to position itself in high growth sectors with differentiated and critical products. This has been achieved through a focus on innovation, either by self-funded R&D or through acquisition to refresh and broaden the group's capabilities to address future growth markets. In addition, Ultra benefits from its geographical strategy with 53% of sales in the US and only 6% direct to the MoD.

Financials reflect strategy

The strategy has allowed a consistency in results producing a three-year CAGR in revenues of c 20% pa, PBT of 17% pa and EPS of 16% pa. Over the same period, the dividend has increased by 18% pa. We forecast that with a rolling 12 month order cover >60% of forecasts, EPS will grow by 7% in 2010 and a further 11% in 2011. We remain confident that Ultra can achieve this despite any weakening outlook in defence.

Sensitivities – risk management reduces nasty surprises

In our view the management structure is central to Ultra's ability to consistently return such healthy results. It has achieved a balance between a healthy dose of entrepreneurialism within the divisions, while still retaining appropriate strategic and risk management control within the lean centre. We feel that this provides an agility that cannot be matched by the larger players, setting it apart in the defence sphere.

Valuation: The quality mid-cap play

While the current rating of 14.2x CY11 EPS / 8.4x EV/EBITDA may appear a tad rich at first glance, we feel this is fully justified given Ultra's track record of delivery, areas of specialism in defence electronics and a strong balance sheet to continue expansion. Our SOTP suggests a fair value of 1,640p.

Price	1,655p*
Market Cap	£1,135m

** price as at 22 September*

Share price graph

Share details

Code	ULE
Listing	FULL
Sector	Aerospace & Defence
Shares in issue	68.57m

Price

52 week	High	Low
	1,739p	1,226p

Balance Sheet as at 31 December 2010*

Net debt/Equity (%)	N/A
NAV per share (p)	275.0
Net cash (£m)	1.8

** estimated*

Business

Ultra Electronics is a global specialist aerospace & defence electronics company with operations across three divisions: Tactical & Sonar Systems (43% 2009 sales), Aircraft & Vehicle Systems (24%) and Information & Power Systems (33%).

Valuation

	2009	2010e	2011e
P/E relative	162%	151%	156%
P/CF	9.3x	10.7x	9.5x
EV/Sales	1.8x	1.6x	1.4x
ROE	37%	39%	43%

Revenues by geography

UK	Europe	US	Other
25%	9%	53%	13%

Analyst

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Exhibit 78: Ultra Electronics divisional description

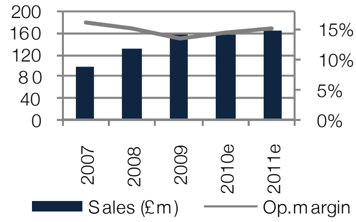
Operations	Performance

Aircraft & Vehicle Systems

The Aircraft & Vehicle System division encompasses a group of major systems and products for use in aircraft and land vehicles. These cover a wide range of applications including ice protection systems, vibration controls, sensors, electronics, man/machine interfaces, software and training services. The business employs c 1,000 people at locations in the UK, North America and the UAE.

H110 results were impacted by the ongoing delays to the Boeing 787 and Airbus A400M and the division's continued investment in these and other new programmes such as the F-35 and Gulfstream G650. This saw revenues decrease by 9% and profits down 17% as a result of higher self-funded qualification work on the 787 and F-35. In addition, the order book decreased by 4% as delays to orders in UK defence programmes, such as FRES, and trading on multi-year Eurofighter contracts occurred.

Outlook: The division is currently in a development investment phase and this is impacting margins and to some extent revenues as the main programmes have been delayed entering production. However, we believe that the long-term outlook for the division is positive and once qualification tests are complete and initial production starts on aircraft such as the 787, and longer-term the F-35, revenues will start to ramp-up significantly, with an associated margin benefit.

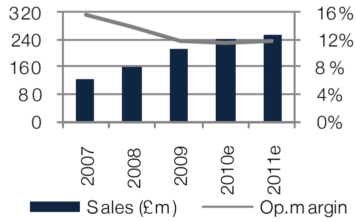


Information & Power Systems

Information & Power Systems designs and manufactures a range of systems related to the management and control of power applications. Information systems are produced for airports, ISTAR systems for military command and control, tracking and surveillance systems as well as naval navigation & data processing. Power systems' capabilities include naval power conversion, signature management of naval vessels and transit power systems, transformers and modular sub-stations for rail and urban transit systems. The division employs c 1,700 people with operations in the UK and North America.

H110 demonstrated the strong performance of the division with growth driven especially by demand for battlespace IT systems across intelligence & surveillance and air defence. As a result, revenues increased by 18% with operating profit increasing 29% as margins recovered to 12.4%. Again, order book growth was only 2% held back by delays in contract placement of nuclear reactor controls for UK submarines.

Outlook*:* The division is set to benefit from an increase in both information and power requirements across a wide range of markets, as well as production of nuclear reactor controls and instrumentation for the UK submarine fleet. Longer-term we view Ultra as having a significant opportunity to expand into the civil nuclear arena through the controls and instrumentation business, although this is some way off in our view.

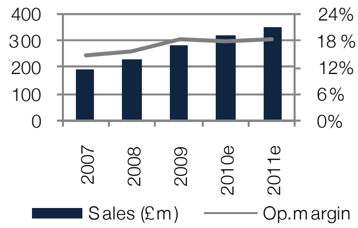


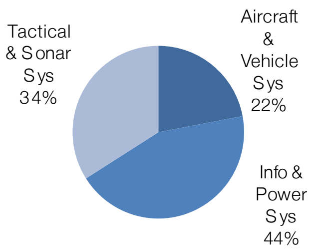
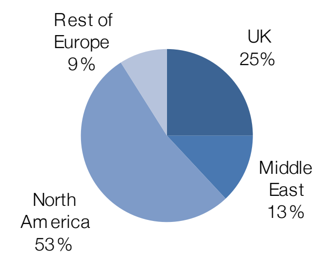
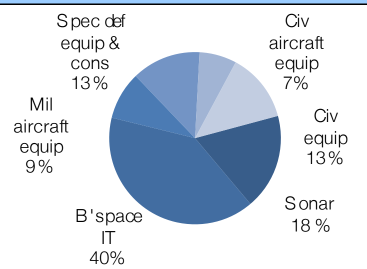
Tactical & Sonar Systems

The other half of Ultra's high growth Battlespace IT business is contained within Tactical & Sonar Systems encompassing data links, cryptographic equipment, radio communication systems, network interface equipment and secure video communication systems. This division also contains the sonar systems, sonobuoys, submarine communications and underwater countermeasures businesses. The division employs c 1,500 people in the UK, North America and Australia.

H110 results highlighted the steady growth profile of TS&S with revenues up 10%, operating profit up 26% and an order book up 20%. Revenue growth was driven by deliveries of anti-submarine warfare systems and strong international battlespace IT demand, especially tactical radio and data link systems to the US through a $650m IDIQ.

Outlook: Short-term demand continues to be driven by orders of line-of-sight tactical radios, as well as further anti-submarine warfare products and importantly, the recent £76m cryptographic programme win in the UK. With increasing demand for enhanced battlespace awareness, we view the outlook as extremely robust, and with the US QDR increasing focus in this area, we believe that double-digit revenue growth is achievable.



Divisional	Geographic	Customer
		

Source: Edison Investment Research

Exhibit 79: Financial summary

£m	2007	2008	2009	2010e	2011e
Year end 31 December	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	412.9	515.3	651.0	713.6	765.0
Cost of Sales	(300.4)	(373.1)	(462.5)	(505.0)	(545.0)
Gross Profit	112.5	142.2	188.5	208.6	220.0
EBITDA	68.6	84.1	105.1	114.3	125.7
Operating Profit (before amort. and except.)	62.9	77.1	97.3	106.3	117.2
Intangible Amortisation	(3.9)	(13.0)	(26.3)	(30.0)	(33.0)
Exceptionals	(0.6)	(62.1)	44.7	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0
Operating Profit	58.5	2.0	115.7	76.3	84.2
Net Interest	(1.9)	(4.9)	(7.8)	(7.5)	(5.0)
Profit Before Tax (norm)	61.1	72.2	89.5	98.8	112.2
Profit Before Tax (FRS 3)	56.6	(2.9)	107.9	68.8	79.2
Tax	(15.4)	4.6	(29.4)	(27.7)	(32.0)
Profit After Tax (norm)	44.3	54.5	65.8	71.1	80.2
Profit After Tax (FRS 3)	41.2	1.8	78.5	41.1	47.2
Average Number of Shares Outstanding (m)	67.7	68.0	68.2	68.8	69.0
EPS - normalised (p)	65.4	80.1	96.4	103.3	116.3
EPS - normalised and fully diluted (p)	65.0	79.7	96.2	102.8	115.7
EPS - (IFRS) (p)	60.9	2.6	115.1	59.7	68.4
Dividend per share (p)	21.2	26.0	31.2	34.5	38.2
Gross Margin (%)	27.2	27.6	29.0	29.2	28.8
EBITDA Margin (%)	16.6	16.3	16.1	16.0	16.4
Operating Margin (before GW and except.) (%)	15.2	15.0	15.0	14.9	15.3
BALANCE SHEET					
Fixed Assets	214.1	391.4	357.8	345.7	318.0
Intangible Assets	179.3	327.8	303.0	274.8	243.6
Tangible Assets	24.2	34.9	36.6	52.7	56.2
Investments	10.6	28.7	18.2	18.2	18.2
Current Assets	154.1	222.7	215.9	225.9	235.9
Stocks	42.4	52.8	50.6	55.6	60.6
Debtors	84.2	126.5	123.4	128.4	133.4
Cash	27.4	43.4	41.8	41.8	41.8
Other	0.0	0.0	0.0	0.0	0.0
Current Liabilities	(138.2)	(232.6)	(273.8)	(203.7)	(212.7)
Creditors	(138.2)	(232.5)	(203.3)	(203.7)	(212.7)
Short term borrowings	(0.0)	(0.1)	(70.5)	(0.0)	(0.0)
Long Term Liabilities	(88.1)	(237.5)	(121.2)	(184.1)	(156.0)
Long term borrowings	(41.6)	(107.2)	0.0	(40.0)	12.2
Other long term liabilities	(46.5)	(130.3)	(121.2)	(144.1)	(168.1)
Net Assets	141.9	144.0	178.6	183.7	185.1
CASH FLOW					
Operating Cash Flow	66.2	94.6	120.9	106.8	120.4
Net Interest	(3.0)	(5.0)	(5.4)	(6.5)	(7.5)
Tax	(13.7)	(20.5)	(13.5)	(22.3)	(25.0)
Capex	(13.3)	(13.7)	(8.8)	(7.0)	(9.8)
Acquisitions/disposals	(31.0)	(78.8)	(30.8)	(16.9)	(2.0)
Financing	1.9	0.7	1.9	1.3	0.0
Dividends	(13.0)	(15.2)	(18.7)	(22.0)	(24.0)
Net Cash Flow	(5.8)	(37.9)	45.7	33.4	52.1
Opening net debt/(cash)	7.1	14.2	63.9	28.7	(1.8)
HP finance leases initiated	0.0	0.0	0.0	0.0	0.0
Other	(1.3)	(11.8)	(10.4)	(2.8)	0.0
Closing net debt/(cash)	14.2	63.9	28.7	(1.8)	(54.0)

Source: Company accounts/Edison Investment Research

Edison investment research

Umeco

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
03/09	410.9	28.5	39.7	17.5	11.0	4.0
03/10	409.4	24.9	36.3	17.5	12.0	4.0
03/11e	421.9	26.4	38.0	18.0	11.5	4.1
03/12e	456.5	30.9	43.9	19.0	9.9	4.3

Note: *PBT and EPS are normalised, excluding intangible amortisation and exceptional items.

Investment summary: Supplying the recovery

Given the difficulties experienced in many of Umeco's end markets, the swift decisions to cut costs ensured the business remained on a sure footing and positioned itself for the recovery. Contracts won in Supply Chain offset a slowdown in aftermarket and composites, however the bottom line was impacted by the loss of the higher margin composites revenues. Importantly, management has actively managed the cash position and significantly reduced net debt, removing the fear of a cash call that plagued the stock over the last 18 months.

Supply chain opportunities continue

Nearly 60% of the business is in the higher visibility Supply Chain business which has allowed management to focus on cash generation and position Umeco to benefit as others look to reduce costs by outsourcing. Through its main customer Rolls-Royce, the business has benefitted from a continual expansion in both scope and value of supply chain contracts. New customer wins over the past three years has seen the addition of Goodrich, Thales, Turbomeca and ATK. Despite continued weakness in the direct aftermarket, we believe FY11 will see progress.

Higher margin composites to return to growth

2010 results were hit by delays in aerospace programmes and automotive and wind energy essentially ground to a halt, with underlying revenues down 15% and 12% in Structural and Process Materials respectively. Management took swift action to reduce headcount & overhead costs and dispose of the loss-making ACG South Africa following the end of the SLR programme. The July IMS highlighted the potential recovery with Structural Materials up 7% and Process up 26% driven by improved demand in aerospace and a stronger than anticipated recovery in wind, which we forecast will strengthen composites further in H2.

Valuation: Has the recovery occurred?

The rating of 10.2x CY11 EPS / 7.3x EV/EBITDA reflects acknowledgement by the market that Umeco operates in inherently good long-term markets with the potential for composites in particular to provide significant value as markets recover. This compares with a forward P/E of c 5.9x at the low-point of the financial crisis. We feel the business has further to go and our SOTP suggests a fair value of 445p.

Price	437p*
Market Cap	£210m

** price as at 22 September*

Share price graph

Share details

Code	UMC
Listing	FULL
Sector	Aerospace & Defence
Shares in issue	48.14m

Price

52 week	High	Low
	440.0p	258.3p

Balance Sheet as at 31 March 2011*

Net debt/Equity (%)	41.0
NAV per share (p)	38.7
Net borrowings (£m)	74.6

** estimated*

Business

Umeco is an international provider of supply chain services and advanced composite materials primarily to aerospace and defence (70%), wind energy (5%), motor sport (7%), marine (4%) and other industries (14%).

Valuation

	2010	2011e	2012e
P/E relative	113%	107%	108%
P/CF	3.5x	5.6x	5.6x
EV/Sales	0.7x	0.7x	0.6x
ROE	10%	10%	12%

Revenues by geography

UK	Europe	US	Other
44%	28%	19%	9%

Analyst
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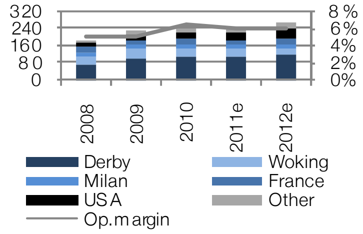
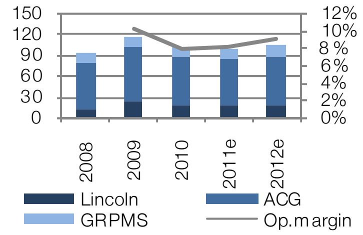
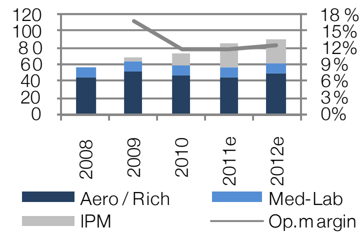
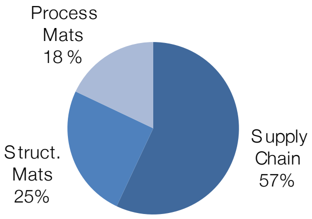
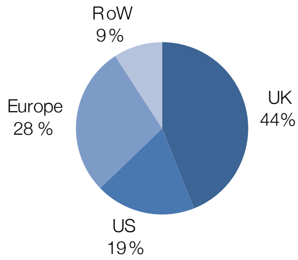
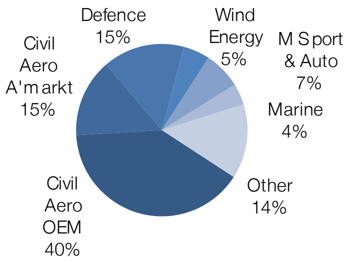
Exhibit 80: Umeco divisional description

Operations	Performance
Supply Chain	
Umeco Supply Chain provides inventory management services, primarily to OEMs in the Aerospace & Defence industry. Its main customers include Roll-Royce, Goodrich, Thales, Turbomeca, BAE Systems and more recently ATK. The division has operations in the UK, France, Italy, US and a developing Asian business. End markets cover civil aerospace OEM (56%) and aftermarket (24%), defence (19%), marine (1%) and other (0.2%). Over the past three years, the business has won several key contracts and contract extensions, equating to approximately £100m of incremental revenues. The largest customer is Rolls-Royce, representing c 50% of divisional revenues. The ramp-up of these contracts has provided a buffer to weaker demand from aftermarket customers and indeed, the business recently won a contract extension to supply Rolls-Royce in the US through Umeco's Fort Worth operation adding c $20m p.a. revenues starting from January 2011. **Outlook:** With an increasing focus from customers on reducing costs and maintaining efficiency, we believe that the outlook for the division remains healthy with a greater number of higher-value parts likely to be managed. Likewise, following a reduction in the cost base and a focus on operational efficiency, the division stands to benefit from an anticipated recovery in demand.	
Structural Materials	
Umeco's Composite Structural Materials division encompasses three main businesses: JD Lincoln, a manufacturer of adhesives and composite materials for specialty applications including aircraft interior structures; ACG, a manufacturer of high performance composite prepreg materials for use in components and tooling, and; GRPMS, a distributor of polyester resin and glass fibre. End markets for the division's products encompass aerospace (33%), motor sport (23%), marine (12%), wind (0.3%) and other (32%). FY10 results were impacted by the difficulties in many of the end markets as activity levels reduced and demand patterns were uncertain. Umeco took swift action to reduce the cost base which included a 13% reduction in headcount and a 12% reduction in direct and overhead costs. In addition, Umeco divested ACG's South African operations which had been a supplier of specialist composites into the Mercedes McLaren SLR programme which came to end in the year. **Outlook:** The US business has been restructured under a single President, Hisham Alameddine, providing greater control of the business. JD Lincoln's operations are also being relocated into a single new leasehold facility which will improve efficiency and capacity over the medium-term. With initial signs of order intake recovery, we anticipate progress as new aircraft programmes enter production and other markets rebound.	
Process Materials	
Umeco's Composite Process Materials division encompasses three main businesses: Aerovac / Richmond - provides vacuum bags and other associated manufacturing materials; IPM – acquired in December 2008, manufactures extruded and co-extruded plastic films for use in vacuum bagging applications and other barrier films; and Med-Lab – a supplier of consumable short shelf-life hazardous goods to airlines and MRO operations as well as electronic test equipment to the Petrochemical industry. End markets encompass aerospace (31%), wind (30%), motor sport & auto (6%), marine (2%) and other (32%). Demand throughout 2009 was significantly impacted by a decline in demand from wind energy following funding difficulties in wind farm projects and the continued delay in the Boeing 787 programme. Actions were taken to improve the operational performance at IPM with a new management team and a move to seven day working to reduce waste, however these benefits were offset by an increase in raw material cost and lower than expected volumes. **Outlook:** With demand in the Chinese Wind Energy market remaining buoyant, Umeco is exploring a potential JV partnership and the hiring of Tony Steels in May 2009 will help development of this market. Elsewhere, aerospace films are being developed at IPM and the relocation of Richmond to a newer facility should allow further improvements to be made. Once again, we feel the progress of 787 and wind energy will be key drivers.	

Divisional	Geographic	Customer
		

Source: Edison Investment Research

Exhibit 81: Financial summary

£m	2008	2009	2010	2011e	2012e
Year end 31 March	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	380.7	410.9	409.4	421.9	456.5
Cost of Sales	(243.0)	(303.1)	(307.8)	(325.0)	(345.0)
Gross Profit	137.7	107.8	101.6	96.9	111.5
EBITDA	30.9	39.7	37.4	39.5	44.5
Operating Profit (before amort. and except.)	27.1	34.7	31.6	32.4	36.4
Intangible Amortisation	(2.3)	(4.2)	(6.3)	(7.0)	(7.0)
Exceptionals	(2.5)	(2.2)	(1.8)	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0
Operating Profit	22.3	28.3	23.5	25.4	29.4
Net Interest	(5.2)	(6.2)	(6.7)	(6.0)	(5.5)
Profit Before Tax (norm)	21.9	28.5	24.9	26.4	30.9
Profit Before Tax (FRS 3)	17.1	22.1	16.8	19.4	23.9
Tax	(6.0)	(8.1)	(4.9)	(7.7)	(9.3)
Profit After Tax (norm)	14.2	19.1	17.7	18.7	21.7
Profit After Tax (FRS 3)	11.1	14.0	11.9	11.7	14.7
Average Number of Shares Outstanding (m)	47.9	48.1	48.3	49.0	49.0
EPS - normalised (p)	29.4	39.7	36.6	38.2	44.2
EPS - normalised and fully diluted (p)	29.4	39.7	36.3	38.0	43.9
EPS - (IFRS) (p)	23.0	29.1	24.6	23.9	29.9
Dividend per share (p)	17.0	17.5	17.5	18.0	19.0
Gross Margin (%)	36.2	26.2	24.8	23.0	24.4
EBITDA Margin (%)	8.1	9.7	9.1	9.4	9.8
Operating Margin (before GW and except.) (%)	7.1	8.4	7.7	7.7	8.0
BALANCE SHEET					
Fixed Assets	158.5	207.1	193.0	190.0	186.0
Intangible Assets	117.2	153.9	144.1	137.1	130.1
Tangible Assets	37.8	49.8	46.5	50.5	53.5
Investments	3.5	3.4	2.4	2.4	2.4
Current Assets	246.7	327.5	309.9	312.9	320.9
Stocks	118.3	170.2	167.8	175.8	185.8
Debtors	92.4	101.2	80.7	75.7	73.7
Cash	33.4	51.8	56.5	56.5	56.5
Other	2.6	4.3	4.9	4.9	4.9
Current Liabilities	(137.1)	(168.4)	(170.8)	(172.5)	(175.7)
Creditors	(135.7)	(163.8)	(169.4)	(171.1)	(174.3)
Short term borrowings	(1.4)	(4.6)	(1.4)	(1.4)	(1.4)
Long Term Liabilities	(105.7)	(187.5)	(153.7)	(148.7)	(143.7)
Long term borrowings	(89.6)	(167.4)	(134.7)	(129.7)	(124.7)
Other long term liabilities	(16.1)	(20.1)	(19.0)	(19.0)	(19.0)
Net Assets	162.4	178.7	178.4	181.7	187.5
CASH FLOW					
Operating Cash Flow	14.4	27.3	59.7	38.5	38.5
Net Interest	(5.3)	(5.3)	(7.0)	(6.0)	(6.0)
Tax	(5.5)	(9.2)	(4.3)	(8.0)	(8.0)
Capex	(11.9)	(5.9)	(3.7)	(10.0)	(10.0)
Acquisitions/disposals	11.3	(27.6)	(0.2)	0.0	0.0
Financing	1.5	0.2	0.0	0.0	0.0
Dividends	(7.7)	(8.4)	(8.4)	(9.5)	(9.5)
Net Cash Flow	(3.2)	(28.9)	36.1	5.0	5.0
Opening net debt/(cash)	51.8	57.6	120.2	79.6	74.6
HP finance leases initiated	0.0	0.0	0.0	0.0	0.0
Other	(2.6)	(33.7)	4.5	0.0	0.0
Closing net debt/(cash)	57.6	120.2	79.6	74.6	69.6

Source: Company accounts/Edison Investment Research

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