

## Leonardo DRS, Inc.

**DRS Investor Day – High visibility, agnostic differentiated tech, focused on M&A**

Reiterate Rating: BUY | PO: 26.00 USD | Price: 21.97 USD

**DRS focused on the long term plan**

We attended DRS' first Investor Day and came away with a positive view on the company's future given their pragmatic approach to growth and capital deployment. The message from the day was clear, 1) DRS has a long line of sight on future growth, 2) their agnostic tech development is opening the door to international and adjacent market opportunities, and 3) they are hungry for more M&A. We reiterate our Buy and increase our PO to \$26, as we see margin expansion opportunities on the Columbia class program (see details inside) and expect more acquisitions in the near future.

**Speak softly and carry a DRS network-enabled stick**

Key to DRS' strategy has been investments in platform agnostic technologies, which are scalable, open, and accessible across services and programs. This strategy should help DRS penetrate programs as both DoD and international militaries focus on modernization, JADC2, unmanned, and AI (see our reports: [here](#), and [here](#)). We see DRS's current product portfolio supporting sensors, full-suite integrated solutions, EO/IR, and on-board computing capturing these long-term trends as the company focuses R&D on integrating and connecting systems across domains. We see additional upside as DRS matures these advancements on products and they become available to international customers.

**Acquisitions focused on mature targets**

While the company is not opposed to smaller acquisitions with unique tech capabilities which support R&D, the primary focus is on targets which should be immediately accretive. Additionally, an ideal acquisition will support building out DRS' current core capabilities: Advanced Sensing, Network Computing, Force Protection, and/or Electric Power & Propulsion. We see it likely for DRS to acquire companies with a strong presence in space, unmanned systems, and surface naval end-market given the strong growth in those areas and complimentary to the current DRS portfolio.

**SC naval facility build out supporting Naval demand**

DRS' South Carolina facility will mainly focus on supporting the Columbia-class ramp, will cost \$120mn over three years, and see initial occupancy in 2026. We think this internal investment is the most constructive use of cash at this time. Additionally, building out the facility could open the door for further electric power and propulsion and broader naval work, like DDG(X).

Estimates (Dec) (US\$)	2021A	2022A	2023E	2024E	2025E
EPS	1.14	0.83	0.73	0.80	1.00
GAAP EPS	1.06	1.88	0.63	0.72	0.92
EPS Change (YoY)	56.2%	-27.2%	-12.0%	9.6%	25.0%
Consensus EPS (Bloomberg)			0.72	0.80	0.97
DPS	0	0	0	0	0
Valuation (Dec)					
P/E	19.3x	26.5x	30.1x	27.5x	22.0x
GAAP P/E	20.7x	11.7x	34.9x	30.5x	23.9x
EV / EBITDA*	19.0x	18.5x	18.1x	15.8x	14.0x
Free Cash Flow Yield*	2.0%	-0.6%	2.5%	3.0%	3.8%

\* For full definitions of *IQmethod*<sup>SM</sup> measures, see page 6.

15 March 2024

## Equity

**Key Changes**

(US\$)	Previous	Current
Price Obj.	22.00	26.00

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**Stock Data**

Price	21.97 USD
Price Objective	26.00 USD
Date Established	14-Mar-2024
Investment Opinion	B-1-9
52-Week Range	10.80 USD - 24.00 USD
Mrkt Val (mn) / Shares Out (mn)	5,770 USD / 262.6
Free Float	27.7%
Average Daily Value (mn)	15.87 USD
BofA Ticker / Exchange	DRS / NAS
Bloomberg / Reuters	DRS US / DRS.OQ
ROE (2023E)	8.7%
Net Dbt to Eqty (Dec-2022A)	4.1%

ASC – Advanced Sensing and Computing

IMS – Integrated Mission Systems

DoD – Department of Defence

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Timestamp: 15 March 2024 03:36AM EDT

# iQprofile<sup>SM</sup> Leonardo DRS, Inc.

## iQmethod<sup>SM</sup> – Bus Performance\*

(US\$ Millions)	2021A	2022A	2023E	2024E	2025E
Return on Capital Employed	8.7%	18.1%	7.5%	7.3%	8.5%
Return on Equity	10.9%	9.6%	8.7%	8.9%	10.2%
Operating Margin	8.2%	20.8%	8.4%	9.6%	10.7%
Free Cash Flow	118	(32)	145	174	221

## iQmethod<sup>SM</sup> – Quality of Earnings\*

(US\$ Millions)	2021A	2022A	2023E	2024E	2025E
Cash Realization Ratio	1.1x	0.2x	1.1x	1.2x	1.2x
Asset Replacement Ratio	1.2x	1.2x	1.0x	1.4x	1.5x
Tax Rate	23.0%	22.9%	12.5%	24.1%	20.2%
Net Debt-to-Equity Ratio	9.6%	4.1%	-2.6%	-9.3%	-16.5%
Interest Cover	6.7x	16.5x	6.6x	7.4x	8.7x

## Income Statement Data (Dec)

(US\$ Millions)	2021A	2022A	2023E	2024E	2025E
Sales	2,879	2,693	2,824	2,982	3,150
% Change	3.6%	-6.5%	4.9%	5.6%	5.6%
Gross Profit	547	575	646	684	722
% Change	10.7%	5.1%	12.3%	5.9%	5.6%
EBITDA	310	318	324	372	421
% Change	15.7%	2.6%	1.9%	14.9%	13.1%
Net Interest & Other Income	(36)	(36)	(47)	(33)	(27)
<b>Net Income (Adjusted)</b>	<b>165</b>	<b>179</b>	<b>194</b>	<b>215</b>	<b>268</b>
<b>% Change</b>	<b>55.7%</b>	<b>8.5%</b>	<b>8.4%</b>	<b>10.9%</b>	<b>24.8%</b>

## Free Cash Flow Data (Dec)

(US\$ Millions)	2021A	2022A	2023E	2024E	2025E
Net Income from Cont Operations (GAAP)	154	405	168	193	248
Depreciation & Amortization	58	65	85	85	83
Change in Working Capital	(65)	(82)	(14)	(15)	(16)
Deferred Taxation Charge	31	(6)	(52)	0	0
Other Adjustments, Net	0	(349)	18	0	0
Capital Expenditure	(60)	(65)	(60)	(89)	(95)
<b>Free Cash Flow</b>	<b>118</b>	<b>-32</b>	<b>145</b>	<b>174</b>	<b>221</b>
<b>% Change</b>	<b>71.0%</b>	<b>NM</b>	<b>NM</b>	<b>20.0%</b>	<b>27.0%</b>
Share / Issue Repurchase	NA	NA	NA	NA	NA
Cost of Dividends Paid	0	0	0	0	0
Change in Debt	(20)	(217)	(12)	(50)	0

## Balance Sheet Data (Dec)

(US\$ Millions)	2021A	2022A	2023E	2024E	2025E
Cash & Equivalents	240	306	467	591	812
Trade Receivables	156	166	151	139	147
Other Current Assets	993	1,235	1,300	1,444	1,513
Property, Plant & Equipment	364	404	402	428	460
Other Non-Current Assets	1,316	1,566	1,601	1,579	1,559
<b>Total Assets</b>	<b>3,069</b>	<b>3,677</b>	<b>3,921</b>	<b>4,181</b>	<b>4,491</b>
Short-Term Debt	41	29	57	7	7
Other Current Liabilities	948	1,013	1,021	1,138	1,199
Long-Term Debt	352	365	349	349	349
Other Non-Current Liabilities	135	143	169	169	169
<b>Total Liabilities</b>	<b>1,476</b>	<b>1,550</b>	<b>1,596</b>	<b>1,663</b>	<b>1,724</b>
<b>Total Equity</b>	<b>1,593</b>	<b>2,127</b>	<b>2,325</b>	<b>2,518</b>	<b>2,766</b>
<b>Total Equity &amp; Liabilities</b>	<b>3,069</b>	<b>3,677</b>	<b>3,921</b>	<b>4,181</b>	<b>4,491</b>

\* For full definitions of iQmethod<sup>SM</sup> measures, see page 6.

## Company Sector

Defense Electronics

## Company Description

Leonardo DRS is a prime contractor and supplier primarily known as a defense electronics manufacturer and services provider. DRS provides solutions across the land, air, sea, space, and cyber domains for a multitude of customers, including all US military branches, other A&D contractors, government agencies, and allied governments and militaries. DRS is predominantly owned by Leonardo SpA, an Italian multinational aerospace and defense firm.

## Investment Rationale

We see Leonardo DRS as well positioned to capture both growth in mission critical and emerging end markets while reaping the benefits of high margin content on legacy platforms. The company's niche electric power offering on the Columbia-class nuclear submarine program provides both sizeable and tangible growth prospects through the outyears that should stand the test of any possible budgetary cuts.

## Stock Data

Average Daily Volume 722,268

## Quarterly Earnings Estimates

	2022	2023
Q1	0.26A	0.07A
Q2	0.23A	0.15A
Q3	0.17A	0.20A
Q4	0.35A	0.31A

## Columbia continues to step up, robust demand at ASC

While margins were compressed in 2023, the margin step up is slated to accelerate through the next two years on account of newer Columbia-class shipset revenues being recognized (#2 underway, beginning #3). We continue to anticipate ~100bps of adjusted EBITDA margin expansion in 2024, largely driven by strength at IMS associated with Columbia-class work. We remain optimistic of this ramp as strong book-to-bills (1.3x and 1.2x for 2023 across ASC and IMS, respectively) across both segments point to a robust pipeline of higher margin content in the medium term.

### IMS – Columbia class program drives revenue visibility through 2035

DRS boasts strong revenue visibility with a growing backlog, which has expanded a total CAGR of 24% since 2018. Over half of this backlog is attributed to the Columbia class programs, providing visibility across the entire program life. The program is projected to contribute an average of \$300mn over the next two years, with a margin expansion to the mid-teens. Revenue contribution is anticipated to surpass \$400mn by 2027, accompanied by margins exceeding the mid-teens.

The company already secured a \$3bn contract for the Columbia class program, which not only provides significant revenue but also offers visibility into the supply chain and ensures continues production through 2035.

### \$120mn investment in Coastal facility – Revenue growth and margin expansion

The \$120mn South Carolina facility will increase CapEx to 4%, above the historic norms of 2% of revenue. CapEx will gradually return to the current level of 2% of revenue by 2027. The investment is expected to drive revenue growth and margin expansion in naval propulsion. This facility will give a clear path to delivering strong returns on invested capital over the life of the Columbia class program and will position the company to capture opportunities from new electrification platforms.

## Intl. markets lead amid expected defense budget increases

DRS anticipates bipartisan support for continued increases in defense budget, due to the intensifying threat environment and advancement of near-peer threats. While they expect a modest overall increase in U.S. defense spending, DRS sees opportunities to offset the slowdown with additional Ukraine and Israel support packages. Additionally, we see an opportunity for DRS to capture strong international demand as U.S. oversees allies are recapitalizing their defense base in response to both Russia and China. DRS aims to expand its exposure to international markets which currently accounts just 10% of its revenue.

## Revenue uptick, margin expansion, and M&A on the radar

### On track for mid-single digit organic growth until 2026

The company has sustained a 4% revenue growth CAGR in recent years, leveraging their unique offerings to command higher prices. Moreover, since listing at the end of 2022, DRS has achieved accelerated organic growth at 7%. The company anticipates organic revenue growth above peers, aiming for solid mid-single digit growth through 2026. Potential revenue growth catalysts include global threats driving increased customer requirements, inflation repricing, and supply chain normalization.

### EBITDA margins to increase as Columbia class enters production

Over the next 3 years, EPS is expected to continue rising, while Adj. EBITDA margins are expected to expand to 14% margin by 2026 from current 11.5%, due to Columbia class and other development programs moving into production, operational growth leveraging, and inflation repricing.

### Book to bill ratio set to surpass 1x, with FCF conversion between 80% - 90%

Since listing at the end of 2022, DRS's backlog has expanded 2.5 times, and the company has returned to normalized FCF conversion rates post COVID supply chain disruptions. They anticipate consistent and efficient FCF conversion going forward,



currently strong at 0.8x of adj. earnings. BTB is targeted to exceed 1x, leading to higher FCF at a conversion rate of 80-90%.

### **Raise PO to \$26, reiterate Buy rating, lower EPS on taxes**

margins on later shipsets. We reiterate our Buy rating as this margin expansion is coupled with robust growth and continued demand across the radar and sensing portfolio.

We raise our PO to \$26 (vs. prior \$22) as we roll our valuation to 2025 estimates. We derive our \$26 PO based on a sum-of-the-parts EV/EBITDA multiple of 13x (unchanged) on the Advanced Sensing and Computing (ASC) 2025e earnings and 17x (unchanged) on the Integrated Mission Systems (IMS) segment.

We lower our 2024 EPS estimate to \$0.80 (vs. prior \$0.85) largely due to higher income tax expense. In the outyears our estimates remains unchanged 2025E: \$1.00, 2026E: \$1.15, 2027E: \$1.25.

## Price objective basis & risk

### Leonardo DRS, Inc. (DRS)

We derive our \$26 PO based on a sum-of-the-parts EV/EBITDA multiple of 13x on the Advanced Sensing and Computing (ASC) 2025e earnings and 17x on the Integrated Mission Systems (IMS) segment. We view an EV/EBITDA multiple as the best way to value the equity as it accounts for the margin expansion expected from newly priced Columbia-class shipsets.

The SOTP valuation implies a 15x multiple, or 1.2x relative multiple to the S&P 500 on 2025 estimates and a 1.0x multiple to the defense primes. A multiple above the broader market and in line with SMID cap defense peers alludes to the company's high growth profile and exposure to long term programs with strongly predictable schedules and funding.

Downside risks to our PO are continued supply chain challenges pertaining to microelectronics, lumpiness of Columbia-class revenues, poor execution on fixed-price programs, continued fixed-price contract awards, poor award activity in the international market, potentially diminished funding for land systems in which DRS supports, and volatility from potential parent company secondary offering.

Upside risks to our PO are even higher-than-expected growth in defense spending, accelerated margin ramp on the Columbia-class program, more cost-plus contract awards, continued strength in the international market, continued funding for land systems, and the gradual reduction in Leonardo SpA's ownership stake.

## Analyst Certification

I, Ronald J. Epstein, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

### US - Aerospace and Defense Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
<b>BUY</b>				
	AerCap Holdings N.V.	AER	AER US	Ronald J. Epstein
	Air Lease Corporation	AL	AL US	Ronald J. Epstein
	Booz Allen Hamilton	BAH	BAH US	Mariana Perez Mora
	BWX Technologies, Inc.	BWXT	BWXT US	Ronald J. Epstein
	CACI International	CACI	CACI US	Mariana Perez Mora
	Crane Co.	CR	CR US	Ronald J. Epstein
	Embraer	ERJ	ERJ US	Ronald J. Epstein
	GE Aerospace	GE	GE US	Ronald J. Epstein
	General Dynamics	GD	GD US	Ronald J. Epstein
	HEICO Corporation	HEI	HEI US	Ronald J. Epstein
	Howmet Aerospace Inc.	HWM	HWM US	Ronald J. Epstein
	KBR	KBR	KBR US	Mariana Perez Mora
	Leidos Holdings	LDOS	LDOS US	Mariana Perez Mora
	Leonardo DRS, Inc.	DRS	DRS US	Ronald J. Epstein
	Northrop Grumman	NOC	NOC US	Ronald J. Epstein
	Palantir Technologies	PLTR	PLTR US	Mariana Perez Mora
	Parsons Corporation	PSN	PSN US	Mariana Perez Mora
	RBC Bearings Inc	RBC	RBC US	Ronald J. Epstein
	Rocket Lab	RKLB	RKLB US	Ronald J. Epstein
	Teledyne Technologies Inc	TDY	TDY US	Ronald J. Epstein
	Textron	TXT	TXT US	Ronald J. Epstein
	TransDigm Group Inc.	TDG	TDG US	Ronald J. Epstein
	Triumph Group	TGI	TGI US	Ronald J. Epstein



**US - Aerospace and Defense Coverage Cluster**

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
<b>NEUTRAL</b>				
	Albany International	AIN	AIN US	Ronald J. Epstein
	Boeing	BA	BA US	Ronald J. Epstein
	Garmin	GRMN	GRMN US	Ronald J. Epstein
	Hexcel Corporation	HXL	HXL US	Ronald J. Epstein
	L3Harris	LHX	LHX US	Ronald J. Epstein
	Lockheed Martin	LMT	LMT US	Ronald J. Epstein
	RTX Corp	RTX	RTX US	Ronald J. Epstein
<b>UNDERPERFORM</b>				
	Bombardier	BDRBF	BDRBF US	Ronald J. Epstein
	Bombardier Inc.	YBBD B	BBD/B CN	Ronald J. Epstein
	CAE Inc.	YCAE	CAE CN	Ronald J. Epstein
	CAE Inc.	CAE	CAE US	Ronald J. Epstein
	Huntington Ingalls Industries	HII	HII US	Ronald J. Epstein
	Mercury Systems	MRCY	MRCY US	Ronald J. Epstein
<b>RSTR</b>				
	Cadre Holdings Inc	CDRE	CDRE US	Ronald J. Epstein

**iQmethod<sup>SM</sup> Measures Definitions****Business Performance**

Return On Capital Employed

Return On Equity

Operating Margin

Earnings Growth

Free Cash Flow

**Numerator**

NOPAT = (EBIT + Interest Income) × (1 – Tax Rate) + Goodwill Amortization

Net Income

Operating Profit

Expected 5 Year CAGR From Latest Actual

Cash Flow From Operations – Total Capex

**Denominator**

Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill

Amortization

Shareholders' Equity

Sales

N/A

N/A

**Quality of Earnings**

Cash Realization Ratio

Asset Replacement Ratio

Tax Rate

Net Debt-To-Equity Ratio

Interest Cover

**Numerator**

Cash Flow From Operations

Capex

Tax Charge

Net Debt = Total Debt – Cash &amp; Equivalents

EBIT

**Denominator**

Net Income

Depreciation

Pre-Tax Income

Total Equity

Interest Expense

**Valuation Toolkit**

Price / Earnings Ratio

Price / Book Value

Dividend Yield

Free Cash Flow Yield

Enterprise Value / Sales

**Numerator**

Current Share Price

Current Share Price

Annualised Declared Cash Dividend

Cash Flow From Operations – Total Capex

EV = Current Share Price × Current Shares + Minority Equity + Net Debt +

Other LT Liabilities

Enterprise Value

**Denominator**

Diluted Earnings Per Share (Basis As Specified)

Shareholders' Equity / Current Basic Shares

Current Share Price

Market Cap = Current Share Price × Current Basic Shares

Sales

Basic EBIT + Depreciation + Amortization

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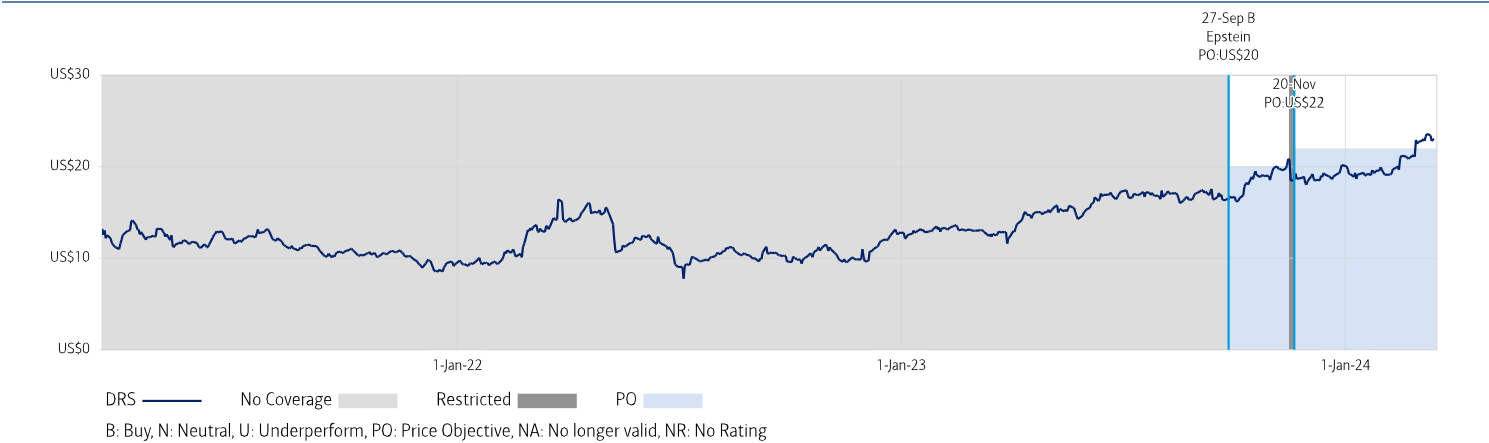
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# Disclosures

## Important Disclosures

### Leonardo DRS (DRS) Price Chart



The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of a date no more than one trading day prior to the date of the report.

### Equity Investment Rating Distribution: Aerospace/Defense Electronics Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships <sup>R1</sup>	Count	Percent
Buy	31	62.00%	Buy	23	74.19%
Hold	11	22.00%	Hold	9	81.82%
Sell	8	16.00%	Sell	6	75.00%

### Equity Investment Rating Distribution: Global Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships <sup>R1</sup>	Count	Percent
Buy	1895	53.62%	Buy	1083	57.15%
Hold	832	23.54%	Hold	454	54.57%
Sell	807	22.84%	Sell	383	47.46%

<sup>R1</sup> Issuers that were investment banking clients of BofA Securities or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster <sup>R2</sup>
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

<sup>R2</sup> Ratings dispersions may vary from time to time where BofA Global Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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