

Northrop Grumman

The best portfolio in the business – reiterate Buy and \$615 PO

Reiterate Rating: BUY | PO: 615.00 USD | Price: 450.00 USD

Worries over B-21 and Sentinel programs overdone

Excluding B-21 and pension charges, Northrop Grumman (NYSE: NOC) strongly exceeded consensus and EPS estimates on topline and EPS ([see 4Q23 results](#)). This was lost amongst investors, but we think worries on the B-21 program and newfound concerns regarding Sentinel/GBSD cost overruns are largely overdone. In our view, there are few negative catalysts ahead to justify NOC's increasingly weak multiple. We reiterate our Buy and \$615 PO.

B-21 high supplier costs, Sentinel costs up on construction

On B-21, while the extent of the charge was above expectations, the prospect of a charge was well telegraphed over the last 12 months. Additionally, as the first LRIP lot was awarded in 4Q23, we see the program continuing along on schedule, further indicating that these charges are supplier cost and timing related. We think the B-21 return on investment will exceed investor expectations. On Sentinel, the company clarified that cost overruns have been on military construction and procurement phases, while progress continues on track at NOC and its suppliers on the EMD phase of the program. To be clear, program cost growth is not necessarily bad for NOC. The EMD phase is cost-plus, that is to say, more cost can translate to more plus on a cost-plus program or, at a minimum, a pass through.

Record backlog of \$84bn supporting long term targets

NOC reached a record backlog of \$84bn at the end of 2023. Additionally, each segment finished the quarter with a book-to-bill ratio above 1.0x, reflecting the still robust demand environment. We expect this backlog to translate into solid topline growth of mid- to high-single digits through the outyears.

Shareholder friendly capital deployment persists

NOC continues to boast strong FCF which it deploys generously to shareholders (125% in 2023). The Board also recently increased its share repurchase authorization by \$2.5bn to \$3.6bn. NOC anticipates at least \$2bn in buybacks through 2024, including an accelerated share repurchase expected soon given NOC's strong liquidity position coming into 2024. In the absence of any capital-intensive projects and/or attractive M&A opportunities, we view buybacks as the most sensible application of capital.

Estimates (Dec) (US\$)	2022A	2023A	2024E	2025E	2026E
EPS	25.54	23.29	24.70	27.75	30.20
GAAP EPS	31.47	13.53	24.71	27.75	30.20
EPS Change (YoY)	-0.3%	-8.8%	6.1%	12.3%	8.8%
Consensus EPS (Bloomberg)			24.61	27.59	29.38
DPS	6.69	7.34	8.05	8.86	9.75
Valuation (Dec)					
P/E	17.6x	19.3x	18.2x	16.2x	14.9x
GAAP P/E	14.3x	33.3x	18.2x	16.2x	14.9x
Dividend Yield	1.5%	1.6%	1.8%	2.0%	2.2%
EV / EBITDA*	17.6x	22.4x	14.8x	13.5x	12.9x
Free Cash Flow Yield*	2.2%	3.1%	3.6%	4.8%	5.8%

* For full definitions of *IQmethod*SM measures, see page 6.

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20 February 2024

Equity

Key Changes

(US\$)	Previous	Current
2024E DPS	8.08	8.05

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Stock Data

Price	450.00 USD
Price Objective	615.00 USD
Date Established	28-Jul-2023
Investment Opinion	B-1-7
52-Week Range	414.56 USD - 496.89 USD
Mrkt Val (mn) / Shares Out (mn)	67,516 USD / 150.0
Free Float	90.5%
Average Daily Value (mn)	492.70 USD
BofA Ticker / Exchange	NOC / NYS
Bloomberg / Reuters	NOC US / NOC.N
ROE (2024E)	24.3%
Net Dbt to Eqty (Dec-2023A)	72.2%
ESGMeter TM	High

ESGMeter is not indicative of a company's future stock price performance and is not an investment recommendation or rating. ESGMeter is independent of BofA Global Research's equity investment rating, volatility risk rating, income rating, and price objective for that company. For full details, refer to ["BofA ESGMeter Methodology"](#).

GBSD – Ground Based Strategic Deterrent

EMD – Engineering and Manufacturing Development

iQprofileSM Northrop Grumman

iQmethodSM – Bus Performance*

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Return on Capital Employed	9.3%	6.7%	10.5%	11.6%	12.3%
Return on Equity	28.1%	23.5%	24.3%	25.5%	25.4%
Operating Margin	9.8%	6.5%	10.7%	11.0%	10.9%
Free Cash Flow	1,466	2,100	2,431	3,216	3,912

iQmethodSM – Quality of Earnings*

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Cash Realization Ratio	0.7x	1.1x	1.2x	1.2x	1.3x
Asset Replacement Ratio	1.1x	1.3x	1.2x	1.1x	1.0x
Tax Rate	16.1%	12.4%	17.0%	17.0%	17.0%
Net Debt-to-Equity Ratio	60.3%	72.2%	75.5%	69.6%	61.4%
Interest Cover	7.1x	4.7x	6.7x	7.2x	7.6x

Income Statement Data (Dec)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Sales	36,602	39,290	41,148	43,992	47,203
% Change	2.6%	7.3%	4.7%	6.9%	7.3%
Gross Profit	7,474	6,551	6,861	7,335	7,870
% Change	2.8%	-12.3%	4.7%	6.9%	7.3%
EBITDA	4,943	3,875	5,881	6,416	6,761
% Change	-28.3%	-21.6%	51.8%	9.1%	5.4%
Net Interest & Other Income	2,235	(191)	15	15	36
Net Income (Adjusted)	3,974	3,540	3,658	4,027	4,296
% Change	-3.6%	-10.9%	3.3%	10.1%	6.7%

Free Cash Flow Data (Dec)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Net Income from Cont Operations (GAAP)	4,896	2,056	3,658	4,027	4,296
Depreciation & Amortization	1,342	1,338	1,488	1,579	1,621
Change in Working Capital	(554)	(152)	(31)	139	270
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	(2,783)	633	(874)	(725)	(574)
Capital Expenditure	(1,435)	(1,775)	(1,811)	(1,804)	(1,699)
Free Cash Flow	1,466	2,100	2,431	3,216	3,912
% Change	-31.9%	43.2%	15.7%	32.3%	21.6%
Share / Issue Repurchase	(1,504)	(1,500)	(2,090)	(1,777)	(1,881)
Cost of Dividends Paid	(1,052)	(1,116)	(1,192)	(1,286)	(1,387)
Change in Debt	0	(1,050)	0	(1,500)	(530)

Balance Sheet Data (Dec)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Cash & Equivalents	2,577	3,109	2,258	1,911	2,025
Trade Receivables	7,494	7,147	6,764	6,930	7,113
Other Current Assets	2,417	3,450	2,912	2,977	2,942
Property, Plant & Equipment	8,800	9,653	10,051	10,334	10,455
Other Non-Current Assets	22,467	23,185	23,649	23,952	24,089
Total Assets	43,755	46,544	45,634	46,103	46,624
Short-Term Debt	0	0	0	0	0
Other Current Liabilities	11,587	11,942	10,990	11,360	11,777
Long-Term Debt	11,805	13,786	13,786	13,286	12,756
Other Non-Current Liabilities	5,051	6,021	5,591	5,121	4,611
Total Liabilities	28,443	31,749	30,367	29,767	29,144
Total Equity	15,312	14,795	15,267	16,336	17,480
Total Equity & Liabilities	43,755	46,544	45,634	46,103	46,624

* For full definitions of iQmethodSM measures, see page 6.

Company Sector

Defense Electronics

Company Description

Northrop Grumman Corp (NOC) is a global defense company headquartered in Falls Church, VA. It provides products, systems, and solutions in information and services, aerospace and electronics. The company is aligned into four primary businesses, namely, Aerospace Systems, Innovation Systems, Mission Systems, and Technology Services.

Investment Rationale

Northrop Grumman is a pure-play defense contractor with high-quality earnings and solid free cash flow generation. Management's investment in internal R&D has paid off with the \$80bn contract win for the Long Range Strike Bomber (B-21). With strong execution, solid balance sheet, increasing dividend and consistent share repurchase, we expect NOC to outperform the market.

Stock Data

Average Daily Volume 1,094,890

Quarterly Earnings Estimates

	2023	2024
Q1	5.50A	6.04E
Q2	5.34A	5.90E
Q3	6.18A	5.95E
Q4	6.28A	6.82E

Defense and Mission seeing outsized growth

Similar to other primes that have reported thus far (LMT, GD), NOC continues to see strong sales and backlog growth across its Defense and Mission Systems segments. We do not believe NOC gets enough attention relative to peers for its exposure to strong legacy munitions and missile work, much of which was acquired through the Orbital ATK acquisition in 2018. In both Defense and Mission Systems, the company's restricted portfolio is a meaningful driver of growth.

Defense: weapons systems to grow faster than average

NOC's Defense Systems business sales decreased 1% Y/Y, however margins expanded ~130bps due to higher net EAC adjustments. Much of the sales decline was due to the timing of material receipts associated with the Integrated Air and Missile Defense Battle Command System (IBCS). However, GMLRS and HACM systems continue to remain in high demand. We expect these weapons systems to see continual upside for the foreseeable future as the geopolitical environment necessitates a bolstering of defense stockpiles, especially among international customers.

Aeronautics: LRIP charge overshadows robust topline

While much of the attention has been focused on the B-21 charge, we highlight that in terms of sales, Aeronautics Systems performed nicely in the year, returning to sales growth earlier than anticipated. We expect high-single digit growth through the outyears as declining volumes on Autonomous Systems are more than offset by ramping B-21 and continued F-35 sales.

Returns on B-21 are still very promising

On one hand, charges are not a good thing. However, on the other hand, we think investors need to consider them in light of the program specifics. That is to say, on B-21, how much risk has NOC actually taken? How much investment, in a commercial sense, has NOC actually made? We would argue, up until this charge, not a lot. Most, if not all, of the risk is born by the DoD. That is how defense contracts work. So, from that perspective, an additional investment of \$1.7bn when compared to owning the franchise for one of the most important programs in the US arsenal does not seem like too high of a price to pay.

Space: continues to be fastest growing segment

NOC's Space Systems continues to be the fastest growing segment in the company's portfolio. Sales increased 10% Y/Y driven by higher restricted program volumes and the ramp-up of development programs. Operating margins decreased primarily as a result of an unfavorable EAC adjustment on the HALO program due to cost growth. Given recent emphasis on the Space Defense Agency's (SDA) Proliferated Warfighter Space Architecture (PWSA) ([read our note here](#)), we see opportunities for NOC to capture additional work on both the Transport and Tracking layers of the program.

15% FCF CAGR through 2026; opps for cap deployment?

Management highlighted a 15% CAGR in free cash flow from 2023 to 2026. Growth is expected to be driven by operation performance, higher CAS recoveries, lower cash tax payments, and lower CapEx starting in 2025. With the considerable strength seen in cash flow, we would not be surprised to see NOC undergo strategic capital deployment initiatives, including further dividend increases and share repurchases. We currently expect a 23% CAGR in FCF over that same time period.

Reiterate 2024 guidance; 4-5% rev. and profit growth

Last quarter, NOC provided a high-level outlook for 2024, expecting 4-5% revenue and profit growth, capex in line with 2023, and free cash flow in the range of \$2.25-\$2.65bn. This quarter, management reiterated the topline expectations and provided additional color as to segment performance. Compared to 2023, NOC is expecting a significant increase in Aeronautics Systems margins, largely due to the B-21 charge taken in 4Q23. At Defense Systems, Mission Systems, and Space Systems operating margins are



expected to be fairly stable Y/Y. Additionally, the easing of macroeconomic headwinds and the implementation of productivity and cost savings initiatives should help expand margins.

Reiterate Buy rating and \$615 PO, raise EPS estimates

We reiterate our Buy rating and PO of \$615 given NOC's strong position on developing programs, robust backlog, and macro-environment creating further demand tailwinds. We derive our PO of \$615 based on a DCF analysis that reflects a 3.5% Y/Y growth rate for 2029-2033e (vs. prior 5%), a 2.7% long term growth rate and a 7.8% discount rate (vs. prior 7.7% on heightened concern around challenged programs like B-21).

We are raising our EPS estimates on higher non-service pension benefits through the outyears. We now expect EPS of \$24.70 (vs. prior \$23.80) in 2024, \$27.75 (vs. prior \$26.95) in 2025, and \$30.20 (vs. prior \$28.80) in 2026.

Price objective basis & risk

Northrop Grumman (NOC)

We derive our PO of \$615 based on a DCF analysis that reflects a 3.5% Y/Y growth rate for 2025-2030e, a 2.7% long term growth rate and a 7.8% discount rate. The US Defense Budget Authorization has grown at a 1.8% CAGR in constant dollars since post World War II. Considering the most profitable production phase of the B-21 Raider program starts in about ten years and the GBSD will enter production at the end of this decade, we expect NOC's next terminal growth rate could exceed the historical growth rate of US defense spending.

Downside risks to our PO are that execution risk on defense programs could result in cost overruns and margin contractions, and unexpected cancellations to programs in both commercial and military could materially impact NOC.

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
BUY				
	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
	Cadre Holdings Inc	CDRE	CDRE US	Ronald J. Epstein
	Crane Co.	CR	CR US	Ronald J. Epstein
	Embraer	ERJ	ERJ 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
	TransDigm Group Inc.	TDG	TDG US	Ronald J. Epstein
	Triumph Group	TGI	TGI US	Ronald J. Epstein
NEUTRAL				
	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
	Textron	TXT	TXT US	Ronald J. Epstein
UNDERPERFORM				
	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



US - Aerospace and Defense Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
	Huntington Ingalls Industries	HII	HII US	Ronald J. Epstein
	Mercury Systems	MRCY	MRCY US	Ronald J. Epstein
	Spirit AeroSys-A	SPR	SPR US	Ronald J. Epstein

iQmethodSM Measures Definitions**Business Performance**

Return On Capital Employed

Return On Equity

Operating Margin

Earnings Growth

Free Cash Flow

Quality of Earnings

Cash Realization Ratio

Asset Replacement Ratio

Tax Rate

Net Debt-To-Equity Ratio

Interest Cover

Valuation Toolkit

Price / Earnings Ratio

Price / Book Value

Dividend Yield

Free Cash Flow Yield

Enterprise Value / Sales

EV / EBITDA

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

Numerator

Cash Flow From Operations

Capex

Tax Charge

Net Debt = Total Debt – Cash & Equivalents

EBIT

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

Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill

Amortization

Shareholders' Equity

Sales

N/A

N/A

Denominator

Net Income

Depreciation

Pre-Tax Income

Total Equity

Interest Expense

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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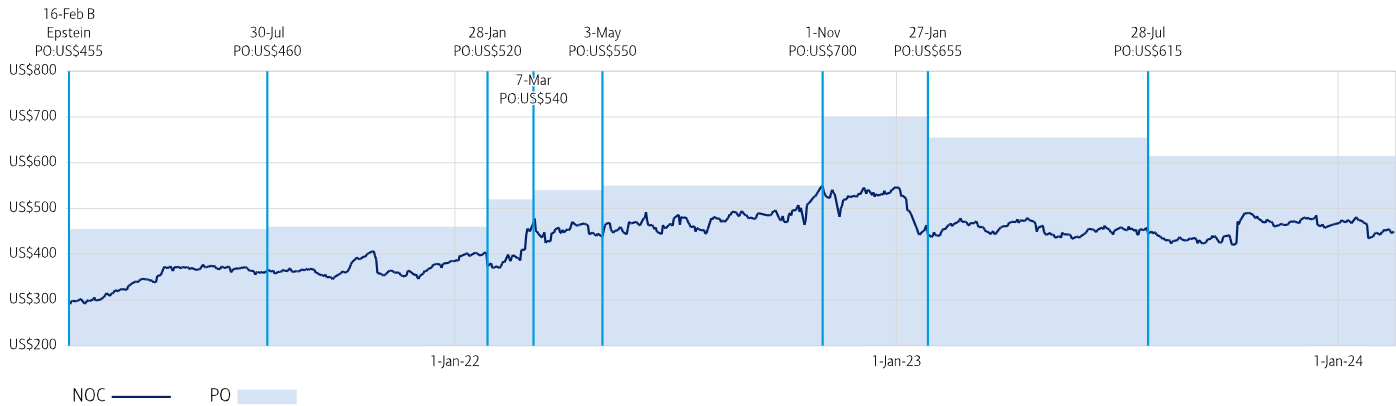
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Disclosures

Important Disclosures

Northrop Grumman (NOC) Price Chart



B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

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 ^{R1}	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 ^{R1}	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%

^{R1} 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 ^{R2}
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

^{R2} 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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