

## Huntington Ingalls Industries

# Uncle Sam sharing CapEx cost, near-term benefits limited – reiterate Underperform

Reiterate Rating: UNDERPERFORM | PO: 250.00 USD | Price: 284.99 USD

## Customer advancements not enough to raise margins

Addressing shipyard capacity and throughput constrains is a major priority for the Department of Defense (DoD). To meet this goal (and to HII's benefit), from 2024-2026 the Navy is to share the cost of CapEx with HII. HII is expected to receive advances on contract incentives to offset the increasing CapEx requirements (up to 5% from 3% of sales). Despite the short term FCF relief, the revenue recognition of the incentives is to be spread over the life of multi-year contracts and likely will not provide a meaningful near-term benefit. We expect low single digit topline growth, and operating margins to decline by 60bps to 7.7% on continued labor constraints and further program delays.

## Skeleton crew just can't hold onto any extra muscle

Labor remains a revolving door at HII. Despite HII hiring 29,000 employees from 2020-2023, 27,000 employees have left the company (See exhibit 1 inside). In 2023 alone, HII hired 9,500 employees (22% of their entire workforce), which only slightly offset the 8,500 employees exiting (19.3% of their entire workforce). The issue of hiring and retaining labor is not unique to HII. However, the high churn coupled with a 3–5-year employee efficiency ramp is alarming. We see the high attrition rates at HII as a major risk to meeting critical milestones on the Virginia and Columbia class submarines, which can negatively impact margins, and risk future opportunities.

## All options on the table for capital deployment in 2024

In 2023, HII paid down \$480mn of debt, paid \$200mn in dividends, and repurchased \$75mn of shares. HII expects to pay down another \$229mn of debt in 2024 and return \$500mn of free cash flow to shareholders. After several years of committing cash to debt repayments, HII is considering M&A opportunities. Optionality is good, that's not deniable. However, we do not see HII as a strong integrator and are skeptical about value creation through M&A in general. We see HII benefiting from taking a more shareholder friendly capital deployment strategy now that debt repayments are less pressing.

## Reiterate Underperform; increase PO to \$250

We reiterate our Underperform rating on continued labor constraints and program delays. We think there are stronger opportunities in the market for Naval modernization. We roll forward our valuation to 2025E (prior 2024E) and increase our PO to \$250 (from \$210), reflecting the market rerating and increased cash from customer funded Capex.

Estimates (Dec) (US\$)	2022A	2023A	2024E	2025E	2026E
EPS	14.44	17.09	16.15	18.25	20.65
EPS Change (YoY)	7.0%	18.4%	-5.5%	13.0%	13.2%
Consensus EPS (Bloomberg)			16.21	18.30	20.17
DPS	4.78	5.02	5.53	6.09	6.70
Valuation (Dec)					
P/E	19.7x	16.7x	17.6x	15.6x	13.8x
Dividend Yield	1.7%	1.8%	1.9%	2.1%	2.4%
EV / EBITDA*	18.3x	14.3x	14.8x	13.3x	12.1x
Free Cash Flow Yield*	4.3%	6.0%	5.8%	6.2%	6.2%

\* For full definitions of *IQmethod*<sup>SM</sup> measures, see page 5.

16 February 2024

### Equity

#### Key Changes

(US\$)	Previous	Current
Price Obj.	210.00	250.00
2024E DPS	5.52	5.53

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### Stock Data

Price	284.99 USD
Price Objective	250.00 USD
Date Established	16-Feb-2024
Investment Opinion	B-3-7
52-Week Range	188.51 USD - 285.12 USD
Mrkt Val (mn) / Shares Out (mn)	11,283 USD / 39.6
Free Float	98.2%
Average Daily Value (mn)	85.22 USD
BofA Ticker / Exchange	HII / NYS
Bloomberg / Reuters	HII US / HII.N
ROE (2024E)	15.3%
Net Dbt to Eqty (Dec-2023A)	49.2%
ESGMeter™	High

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Timestamp: 16 February 2024 03:00AM EST

# iQprofile<sup>SM</sup> Huntington Ingalls Industries

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

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Return on Capital Employed	5.5%	7.4%	6.9%	7.7%	8.5%
Return on Equity	18.4%	18.0%	15.3%	16.2%	17.2%
Operating Margin	5.3%	6.8%	6.2%	6.7%	7.1%
Free Cash Flow	482	678	649	698	694

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

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Cash Realization Ratio	1.3x	1.4x	2.0x	1.9x	1.6x
Asset Replacement Ratio	1.3x	1.3x	2.6x	2.3x	2.0x
Tax Rate	19.5%	20.2%	21.0%	21.0%	21.0%
Net Debt-to-Equity Ratio	69.9%	49.2%	43.0%	37.7%	32.9%
Interest Cover	5.5x	8.2x	8.2x	9.2x	10.2x

## Income Statement Data (Dec)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Sales	10,676	11,454	11,717	12,185	12,672
% Change	12.1%	7.3%	2.3%	4.0%	4.0%
Gross Profit	1,440	1,646	1,640	1,736	1,837
% Change	5.3%	14.3%	-0.3%	5.9%	5.8%
EBITDA	783	1,000	969	1,077	1,187
% Change	8.8%	27.7%	-3.1%	11.2%	10.2%
Net Interest & Other Income	154	72	78	82	91
<b>Net Income (Adjusted)</b>	<b>579</b>	<b>681</b>	<b>640</b>	<b>706</b>	<b>780</b>
<b>% Change</b>	<b>6.4%</b>	<b>17.6%</b>	<b>-6.1%</b>	<b>10.4%</b>	<b>10.4%</b>

## Free Cash Flow Data (Dec)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Net Income from Cont Operations (GAAP)	579	681	640	706	780
Depreciation & Amortization	218	219	238	265	290
Change in Working Capital	(192)	387	166	40	(20)
Deferred Taxation Charge	2	(113)	0	0	0
Other Adjustments, Net	159	(204)	227	296	214
Capital Expenditure	(284)	(292)	(621)	(609)	(570)
<b>Free Cash Flow</b>	<b>482</b>	<b>678</b>	<b>649</b>	<b>698</b>	<b>694</b>
<b>% Change</b>	<b>12.4%</b>	<b>40.7%</b>	<b>-4.2%</b>	<b>7.5%</b>	<b>-0.5%</b>
Share / Issue Repurchase	NA	NA	NA	NA	NA
Cost of Dividends Paid	(192)	(200)	(219)	(236)	(253)
Change in Debt	(400)	(480)	(229)	0	0

## Balance Sheet Data (Dec)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Cash & Equivalents	467	430	381	543	684
Trade Receivables	1,876	1,998	1,942	1,936	1,979
Other Current Assets	403	452	466	469	473
Property, Plant & Equipment	3,198	3,296	3,679	4,023	4,303
Other Non-Current Assets	4,913	5,039	4,929	4,830	4,750
<b>Total Assets</b>	<b>10,857</b>	<b>11,215</b>	<b>11,398</b>	<b>11,802</b>	<b>12,190</b>
Short-Term Debt	399	231	231	231	231
Other Current Liabilities	2,496	2,801	3,139	3,480	3,760
Long-Term Debt	2,506	2,214	1,985	1,985	1,985
Other Non-Current Liabilities	1,967	1,876	1,780	1,672	1,553
<b>Total Liabilities</b>	<b>7,368</b>	<b>7,122</b>	<b>7,135</b>	<b>7,368</b>	<b>7,529</b>
<b>Total Equity</b>	<b>3,489</b>	<b>4,093</b>	<b>4,264</b>	<b>4,434</b>	<b>4,661</b>
<b>Total Equity &amp; Liabilities</b>	<b>10,857</b>	<b>11,215</b>	<b>11,398</b>	<b>11,802</b>	<b>12,190</b>

\* For full definitions of iQmethod<sup>SM</sup> measures, see page 5.

## Company Sector

Defense Electronics

## Company Description

Headquartered in Newport News, VA, HII is split between three operating segments, Ingalls, Newport News, and Mission Technologies. It supplies and builds amphibious assault and expeditionary ships, builds National Security Cutters and DDG-51s, designs, builds and refuels nuclear-powered aircraft carriers, designs and builds nuclear-powered submarines and provides design, engineering, construction and life cycle support of major surface ship programs for the U.S. Navy.

## Investment Rationale

HII is a pure play on the US Navy. The company is a direct beneficiary of the U.S. pivot to the Pacific and the incrementally positive outlook for the U.S. Navy spending. The Pacific is a hotbed of maritime activity particularly as China expands its territorial waters. As the U.S. focuses more on naval superiority and improving global presence without committing ground troops, we may see upside to shipbuilding spending. That said, we think it is largely reflected in the valuation at this time.

## Stock Data

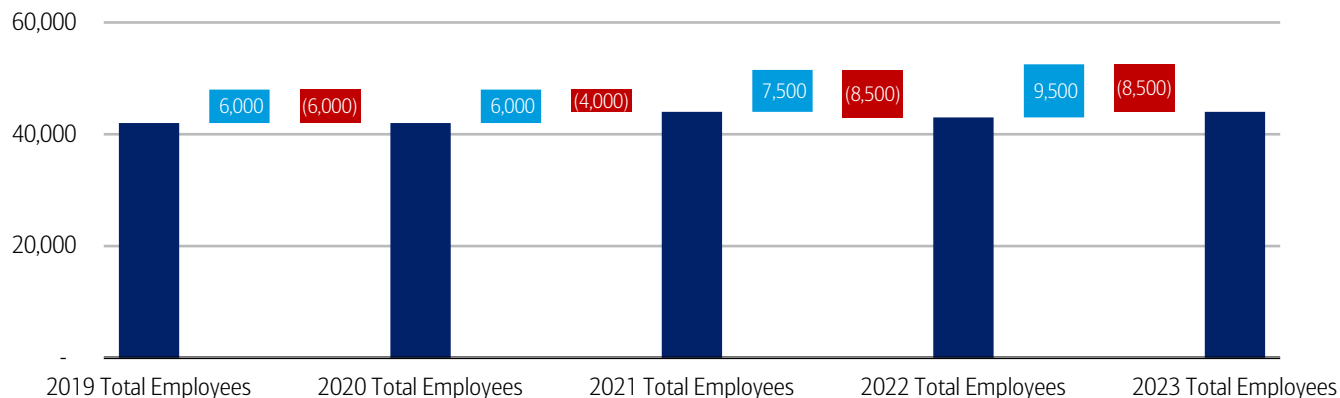
Average Daily Volume 299,034

## Quarterly Earnings Estimates

	2023	2024
Q1	3.23A	NAE
Q2	3.27A	NAE
Q3	3.70A	NAE
Q4	6.90A	NAE

**Exhibit 1: HII Employee Base Hiring and Turnover Trends**

As a % of Total Employees, HII's turnover has exceed 19% in the last two years



Source: BofA Global Research, Company Filings

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**3 program delays pressure 2024 milestone timeline**

We were disappointed to see three major milestones slated for 2023 pushed into 2024. At Newport News, while two milestones related to the Virginia Class Submarine were essentially complete, there were late “breaking changes” on each ship that needed to be managed. At Ingalls, the company ran into issues with the LPD 29 ship, requiring a root cause corrective action and pushing delivery until late 1Q24 or early 2Q24. In our view, these pushouts put pressure on 2024 deliveries. We question whether HII will be able to meet its upcoming milestones as expected, particularly given continued hiring challenges.

**Another \$229mn of debt reduction expected in 2024**

During 2023, HII engaged in \$480mn of debt reduction, \$200mn in dividend payments, and \$75mn of share repurchases. The company expects to pay down another \$229mn of debt in 2024 and return \$500mn of free cash flow to shareholders. Over the past several years, HII has had to commit a significant amount of cash to paying down debt. We think the company could benefit from taking a more shareholder friendly capital deployment strategy now that debt repayments are less pressing.

**Lowering margin expectations on labor constraints**

We updated our model to reflect the customer funded Capital Expenditures through contract advancements, which raises our free cash flow estimates in 2024, and partially offsets lower margin expectations. We anticipate continued headwinds in shipbuilding, and lower margins to 7.7% (vs. prior 8.3%). Additionally, we lower our Mission Tech revenue growth expectations to 1% Y/Y (vs. prior 6%), and EBITDA margins of 8.2% (vs. prior 8.6%), reflecting contract losses and JV divestiture. The lower projections for revenue and margins result in lower EPS expectations. EPS 2024E: \$16.15 (vs. prior \$16.90), 2025E: \$18.25 (vs. \$19.20), 2026E: \$20.65 (vs. prior \$21.60).

**Raise PO to \$250 on stronger FCF & market re-rating**

We roll forward our valuation base to 2025E (from 2024E) and increase our PO to \$250 (prior \$210). We derive our PO of \$250 using a P/FCF multiple of 0.7x (unchanged) relative to the S&P 500 on 2025 estimates, resulting in a 15x multiple (13.5x prior). This is in line with the historical average of 0.8x and factors in robust Navy exposure in a rising defense spending environment offset by persistent supply chain and labor challenges. The US Navy advances to help fund CapEx requirements increase FCF to \$649mn from \$622mn in 2024e and to \$698mn from \$692mn in 2025e.



## Price objective basis & risk

### Huntington Ingalls Industries (HII)

We derive our PO of \$250 using a P/FCF multiple of 0.7x relative to the S&P 500 on 2025 estimates, resulting in a 15x multiple. This is in line with the historical average of 0.8x and factors in robust Navy exposure in a rising defense spending environment offset by persistent supply chain and labor challenges.

Upside risks to our PO are: if the US government's "pivot to the Pacific" strategy involves procuring more ships than we forecast and margins continue to expand beyond expected. Higher share repurchases could provide upside to reported EPS. Accretive acquisitions could increase future expected earnings.

Downside risks to our PO are: Cost overruns derail the company's plan to maintain operating margins above 9%. The Navy takes a budget cut and reduces current fleet procurement. Weaker than expected synergies from announced acquisitions.

## 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
	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
<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
	Textron	TXT	TXT US	Ronald J. Epstein
<b>UNDERPERFORM</b>				
	Bombardier	BDRBF	BDRBF US	Ronald J. Epstein
	Bombardier Inc.	YBBD B	BBD/B CN	Ronald J. Epstein

**US - Aerospace and Defense Coverage Cluster**

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
	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
	Spirit AeroSys-A	SPR	SPR 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

**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 &amp; 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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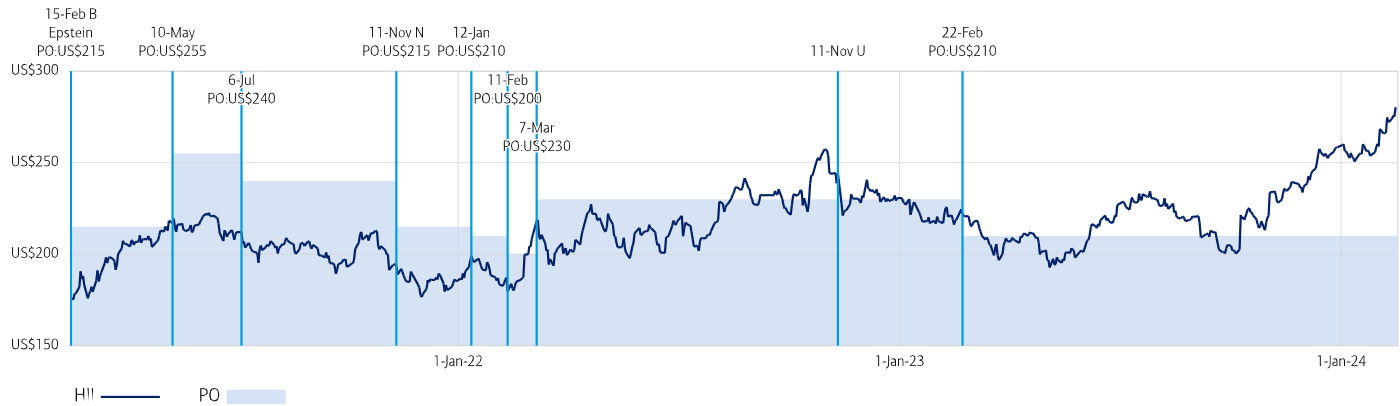
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### Huntington Ing Ind (HII) Price Chart



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 <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%

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