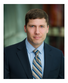
Defense Contractors Covid-19 Outlook

BI Defense Primes, Global Dashboard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1. Covid-19 Outlook: U.S. Defense Contractors

(Bloomberg Intelligence) -- THESIS: The demand side is solid for defense contractors, supported by strong backlogs and a healthy U.S. defense budget. The stimulative effects that defense spending can offer to a weakening economy should limit downside risk to near-term revenue and defense spending. Accelerating government cash payments will help support a fragile supply chain and liquidity is ample. Capital-allocation efforts should be supported. Budget constraints risks the view of a stable military budget in the mid-to-longer term. Key Air Force, Navy and strategic programs aligned with the national defense strategy are likely prioritized in a more difficult budget environment. (04/09/20)

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Revenue: Backlogs, Budgets Support Demand

Defense Revenue Supported by Backlogs, Near-Term Budget

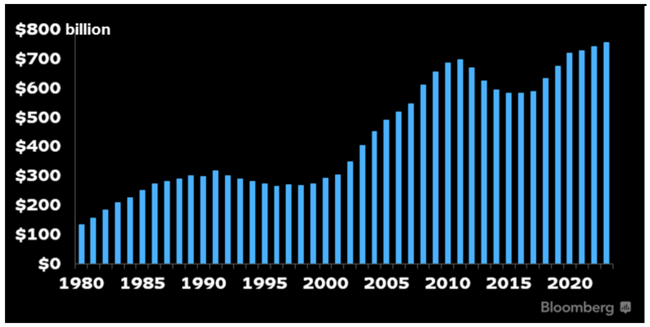
Defense-driven revenue is supported in the near term by strong backlogs and demand, as Pentagon spending will persist, though some risk of manufacturing delays is apparent. General Dynamics, Raytheon and Boeing will likely see sizable revenue cuts, given their commercial exposure. Rising budget constraints may weaken the sector's revenue outlook longer term. (04/06/20)

2. Sound Budgets Drive Revenue; Longer-Term Risks Rising

The upcoming U.S. election and need to support high-paying domestic manufacturing jobs amid the weakening economic environment should minimize downside risks to near-term defense spending. The F-35, for example, affects jobs across all 50 states, and such spending can act as a stimulus amid broader economic challenges. This, and solid backlogs, should support mid-single-digit revenue expectations across the defense sector through 2020, in our view. Longer term, a flatter defense budget outlook has more downside risk, given the increasingly strained U.S. government budget and rising deficits.

Lockheed, Northrop and Huntington Ingalls appear best placed, as the majority of their revenue is defense driven. Boeing, General Dynamics and Raytheon have greater downside revenue risk, given their larger commercial exposure. (04/06/20)

U.S. Defense-Spending Outlays

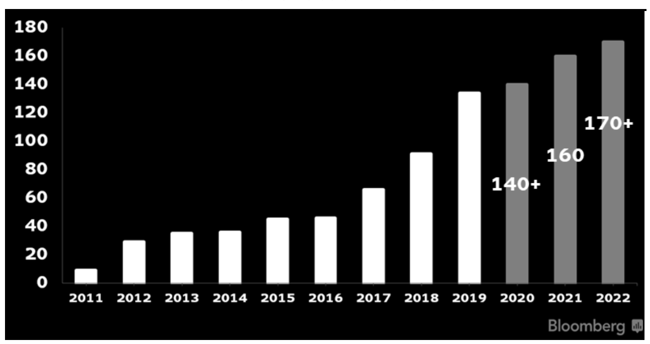


Source: Bloomberg Intelligence

3. Production Risks May Delay Revenue, Yet Demand Solid

Defense-related production shutdowns -- as seen with Italy's brief F-35 plant closure as well as Boeing's KC-46 and P-8 line halt -- and overseas supply chains offer risks to defense-contractor revenue in the near term amid the coronavirus outbreak. Still, the effect is likely to be minimal overall, we believe, and may only defer some revenue to 2H. The Department of Defense has deemed defense contractors critical infrastructure to national security, indicating a need to keep production and supply moving. (04/06/20)

F-35 Production Outlook



Source: Lockheed Martin

Supply Chain: Virus Risks Interruption

Lockheed, Pentagon Speed Cash to Support Fragile Supply Chain

The severe commercial aviation downturn may lead to supplier disruptions for the defense sector, especially in lower-tier, smaller suppliers with more reliance on commercial revenue. Plans by the Defense Department and Lockheed to speed up cash through the supply chain highlights the concern and efforts to keep manufacturers healthy. (04/06/20)

4. Lockheed, Government Hasten Cash to Suppliers

The Pentagon's plan to increase progress payments and Lockheed's effort to front cash to its supply chain show efforts to minimize risks and keep smaller manufacturers healthy. This should help keep production and delivery plans on path for the year, we believe, though early 2020 disruptions may push revenue to 2H.

Keeping the supply chain healthy will be vital to realizing the rising production plans across key programs, such as the F-35. (04/06/20)

Company Press Release

"We will advance more than $50 million to small- and medium-sized business partners in our supply chain to ensure they have the financial means to continue to operate, sustain jobs, and support the economy."

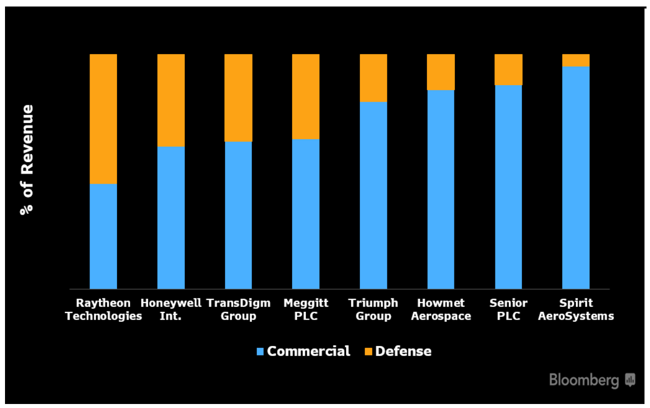
Marillyn Hewson - President/CEO, Lockheed Martin
March 27, 2020

Click to view entire press release

5. Commercial Decline a Risk for Defense

The severe commercial aviation downturn amid the coronavirus outbreak, which is forcing production cuts and sapping demand for profitable aftermarket parts, may risk cascading supply-chain disruptions across defense programs. The effect may be more pronounced among lower-tier, less capitalized suppliers with commercial business exposure than with major contractors such as Raytheon Technologies and Spirit AeroSystems. Suppliers, including TransDigm and Honeywell, have boosted liquidity to blunt the effects of the demand disruption. (04/06/20)

Defense vs. Commercial Revenue



Source: Bloomberg

Liquidity: Anchored by $60 Billion Available

6. As Virus Creates Volatility, Defense Liquidity Tops $60 Billion

Contributing Analysts Matthew Geudtner (Credit)

The March sale of $7.5 billion of bonds by large defense companies demonstrates the sector's ability to access debt, even as the coronavirus creates volatility in credit markets. Defense contractors remain well-positioned to withstand the economic turmoil given their ample liquidity, free cash generation and stable near-term defense budgets. (04/07/20)

7. Liquidity Bolstered by $7 Billion of Bond Sales

Contributing Analysts Matthew Geudtner (Credit)

Despite volatility due to the coronavirus, debt offerings by General Dynamics, Northrop Grumman, L3Harris and Huntington Ingalls in March highlight that markets remain open to high-quality issuers like defense companies, which are typically stable cash generators with products and equipment that are used to ensure U.S. military readiness. Liquidity for large U.S. defense contractors may exceed $60 billion, after accounting for $7.5 billion in proceeds from March issuance, consisting of over $20 billion of availability under credit facilities and $40 billion of cash. About half of the $14 billion in short-term debt for large defense contractors stems from Boeing, while excess cash flow excluding Boeing may exceed $13 billion in 2020. (04/07/20)

Defense Liquidity

Ticker	GD US Equity	LMT US Equity	NOC US Equity	LHX US Equity	HII US Equity
	GENERAL DYNAMICS	LOCKHEED MARTIN	NORTHROP GRUMMAN	L3HARRIS TECHNOL	HUNTINGTON INGAL
Most Recent Qtr	12/19 Q4	12/19 Q4	12/19 Q4	12/19 Q4	12/19 Q4
Currency	USD	USD	USD	USD	USD
Cash & Equivalents	902	1,514	2,245	824	75
Revolver Availibility	5,000	2,500	2,000	2,000	1,234
Liquidity Adjustments	4,000	-	2,250	250	1,000
Total Liquidity	**9,902**	**4,014**	**6,495**	**3,074**	**2,309**
Short-Term Debt	2,987	1,250	1,109	260	-
Long-Term Debt	13,297	11,404	15,020	6,944	2,286
Total Debt	**16,284**	**12,654**	**16,129**	**7,204**	**2,286**

Source: Bloomberg Intelligence

8. Rater Outlooks Flashing Red for Some

Contributing Analysts Matthew Geudtner (Credit)

Liquidity for the sector is strong, yet there remains the potential for rating activity among U.S. defense contractors, namely Boeing and General Dynamics, with about $35 billion of debt on negative outlook or watch. Boeing rating risk remains elevated, given the deterioration in credit metrics owing to the Max grounding and uncertainty around the duration and magnitude of impacts from the coronavirus on aircraft demand and travel.

Proceeds from General Dynamics' tap are being used in part to refinance 2020 maturities, key given that rater outlooks assume the pandemic hurts demand for Gulfstream and related aftermarket services, which may pressure earnings and cash flow. (04/07/20)

Defense Contractor Outlooks

	LT Issuer Rating	Outlook		
Company	Moody's / S&P / Fitch	Moody's	S&P	Fitch
GENERAL DYNAMICS	A2 / A *- / WD			
RAYTHEON CO	A3 / A+ *- / A-			
BOEING CO/THE	Baa1 *- / BBB *- / BBB			
LOCKHEED MARTIN	A3 / A- / A-			
UNITED TECH CORP	Baa1 *+ / BBB+ *+ / WD			
NORTHROP GRUMMAN	Baa1 / BBB / BBB			
L3HARRIS TECHNOL	Baa3 / BBB / BBB			
HUNTINGTON INGAL	Baa3 / BBB / BBB-			

Bloomberg

Source: Bloomberg Intelligence

Use of Cash: Dividends, Buyback Plans Sound

Defense Dividends, Buybacks Sound on Solid Cash Flow

Defense contractors' shareholder-return efforts should be largely supported through 2020, we believe. Raytheon, which is pausing share repurchases, is an outlier, as its recent merger brings significant commercial-aerospace risks. Free-cash generation should remain robust as record backlogs are filled. Huntington Ingalls sees M&A opportunities. (04/08/20)

9. Cash Flow, Margin Outlooks to Hold

High-single to low-double-digit free-cash flow margin expectations for the large defense contractors appear sound, in our view, supported by record backlogs and long-term contracts. Raytheon's defense business and L3Harris enjoy above-peer profitability given their strong market positions and focus on high-value electronics and radars. L3Harris could see 50-100 bps of margin accretion in the coming years, we believe, amid plans to shed noncore and likely lower-margin businesses. Huntington Ingall's cash generation will improve in the coming years as a heavy capital-spending cycle fades, driving its efforts for acquisitions. (04/08/20)

Estimated 2020 Cash Flow, Profit Margin

	Free Cash Flow Margin	Ebitda margin	EbitdaP margin
Lockheed	9.4%	15.7%	19.0%
Northrop	9.5%	14.8%	19.3%
Raytheon	11.9%	18.3%	n/a
General Dynamics	8.5%	14.0%	16.0%
L3Harris	13.9%	19.6%	n/a
Huntington Ingalls	6.3%	14.2%	18.3%

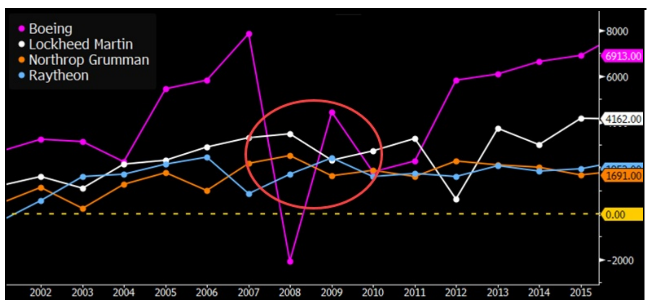
Note: EbitdaP includes FAS/CAS adjustment   Bloomberg

Source: Bloomberg Intelligence

10. Defense Budget, Contracts Support Cash Flow

Long-term contracts and the recent defense-spending upcycle, which has driven backlogs to record levels across most of the large U.S. defense contractors, support near-term cash-flow expectations for the sector, in our view. Free cash flow for Lockheed, Northrop and Raytheon was largely intact through the economic contraction in 2009, while commercial-heavy Boeing saw a decline. (04/08/20)

Historical Free Cash Flow



Source: Bloomberg Intelligence

Foreign Defense Sales May Slow

Overseas Military Sales May Slow as Global Economies Struggle

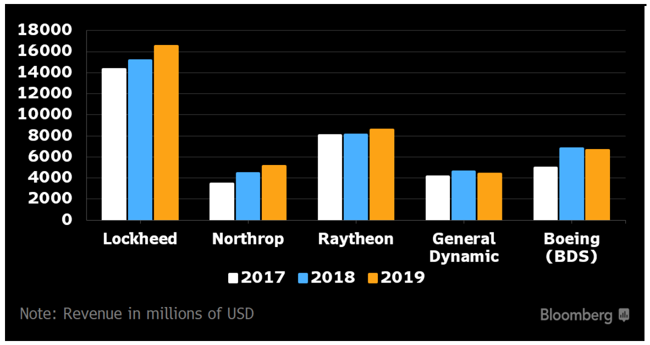
Foreign sales may moderate for U.S. defense contractors -- Raytheon and Lockheed get about 30% of revenue from overseas -- as the coronavirus outbreak and economic weakness weighs on nations' budgets. Tensions with Iran may support Middle East demand, but the region may not escape the virus' economic impact. (04/02/20)

11. Strong Overseas Sales Growth May Wane

International sales rose at a high-single-digit pace for Lockheed and Raytheon in 2019, amid rising F-35 deliveries and strong demand for missile defense and munitions systems. While the F-35 delivery pace should continue to bode well for Lockheed and Northrop, broader overseas sales demand may moderate as government budgets confront a sharply weaker economic environment, risking defense-spending plans.

Overseas customers account for about a quarter of the group's revenue, though represent 30% for some. This is up from 15% a decade ago. (04/02/20)

Non-U.S. Defense Revenue



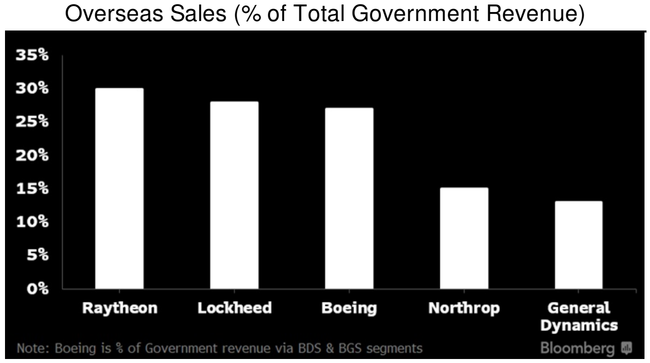
Source: Bloomberg

12. Weaker Overseas Sales May Risk Margin

A weaker overseas sales environment may present a headwind to profitability, as international contracts tend to be for higher-margin, in-production platforms that have already benefited from efficiencies developed over many years of output and cost amortization. Such sales make up 30% of Raytheon's revenue and about 40% of the company's backlog, the most among peers, supporting its above-average profit margins. Strong global demand for Raytheon's Patriot missile-defense system also aids Lockheed, maker of the PAC-3 missile, so do accelerating international F-35 deliveries.

Global demand for the F-15 and F/A-18 fighters, and commercial-derivative aircraft such as the P-8 Poseidon, has supported foreign-sales opportunities for Boeing and subcontractors. (04/02/20)

Overseas Sales (% of Total Government Revenue)

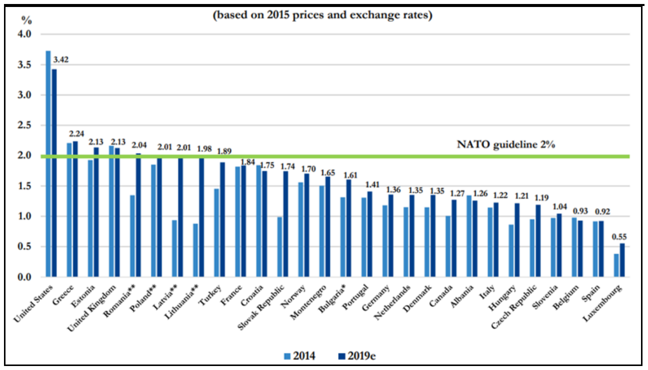


Source: Company filings

13. Headwinds May Clip NATO Defense Spending

NATO members have boosted defense spending over the past few years, yet plans for even more expansion may not be realized as governments grapple with economic risks and funding stimulus programs. Eight NATO member states were at least near the guideline to spend 2% of their countries' GDP on defense in 2019, based on the alliance's June report. But almost twice as many are already meeting the target for equipment spending as a percentage of total outlay. Both metrics are up from 2014, highlighting members' efforts to improve forces. Still, European nations and Canada spend less than 2% of GDP collectively, well below the U.S.'s 3%-plus. (04/02/20)

Equipment Spending (% of Defense Spending)



Source: NATO report, June 2019

Budget Request Portends Slower Growth

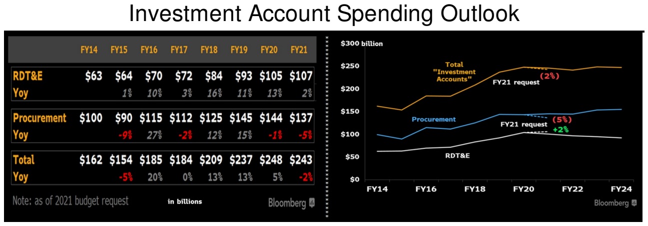
Defense Revenue Growth May Slow as Investment Accounts Trimmed

The president's latest defense budget request shows a 2% decline in combined R&D and procurement spending, indicating revenue growth for Lockheed, Northrop and peers may moderate in coming years. Key aircraft are well funded in 2021, aiding Boeing, and space systems continues to be an area of strong growth, supporting Northrop. (02/12/20)

14. Investment-Account Cuts Show Revenue May Moderate

The White House's 2021 defense budget request continues to support development of new programs, as seen by the 2% increase in R&D spending. Yet the trade-off is seen in the 5% decline in procurement funding, as the Pentagon balances purchasing today's equipment and investing in the future. Strong backlogs, and the lag between defense-spending outlays and the budget, support expectations for mid-single-digit sector revenue growth through 2020. Yet, the flat-to-down outlook of the key investment account suggests overall defense-sector revenue may slow in coming years. (02/12/20)

Investment Account Spending Outlook



	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21
RDT&E	$63	$64	$70	$72	$84	$93	$105	$107
Yoy		1%	10%	3%	16%	11%	13%	2%
Procurement	$100	$90	$115	$112	$125	$145	$144	$137
Yoy		-9%	27%	-2%	12%	15%	-1%	-5%
Total	$162	$154	$185	$184	$209	$237	$248	$243
Yoy		-5%	20%	0%	13%	13%	5%	-2%

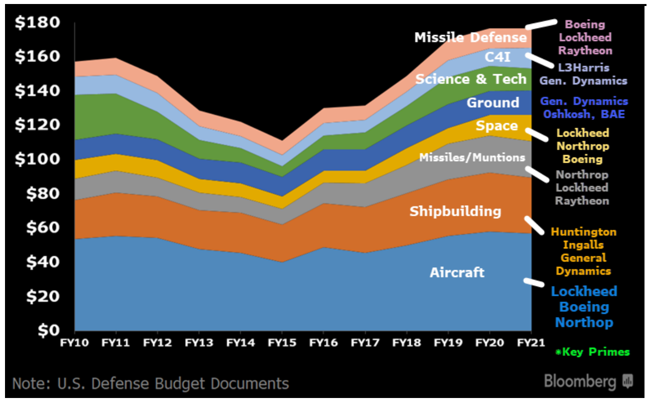
Note: as of 2021 budget request in billions Bloomberg

Source: Bloomberg Intelligence

15. Space Funding Accelerates, Shipbuilding Declines

The elevated U.S. defense budget is driven by funding needs for major aircraft, ships and missile systems, and plays into the capabilities of large defense contractors as the U.S. seeks to replenish aging systems and improve capabilities. Space-based systems, while smaller at about $15 billion annually, continue to be an area of outsized growth. Space assets are integral for supporting and improving military communications, missile defense and navigation capabilities. Shipbuilding funds, while robust at over $30 billion annually for a fourth year, are seen declining in 2021. (02/12/20)

Spending by Segment



Source: Bloomberg Intelligence

16. What the 2021 Defense Budget Means for Contractors: Webinar

The fiscal 2021 U.S. defense budget top line largely adheres to the parameters set in the 2019 Bipartisan Budget Agreement, yet procurement of new programs, such as the F-35 and Virginia-class submarine, were traded off for investments in new technology such as hypersonic systems, and nuclear deterrence. Congress is likely to restore key programs closer to prior-year levels, though a budget battle looms given the below-expectations nondefense spending request. The flattening investment-account spending outlook suggests moderating revenue growth for defense contractors in the coming years.

In a Feb 12 webinar, Avascent's managing director Doug Berenson, and Bloomberg Intelligence's George Ferguson and Doug Rothacker discuss the implications of the fiscal 2021 U.S. defense budget. (02/18/20)

Webinar:
- Transcript
- Slides
- Webinar Replay - sign up as if for the webinar, an email will be sent with a link.

Additional Reading:
- Flatter U.S. Defense Budget Suggests Moderating Sector Revenue Growth
- U.S. Election Will Shape Medium-Term Defense Spending Trajectory.

Election Decides Defense Spend

U.S. Defense Budgets to Edge Higher Until Election Sets Course

Contributing Analysts Francois Duflot (Aerospace)

U.S. defense spending is set to rise through fiscal 2021, with a 3% increase for fiscal 2020 benefiting contractors including Lockheed, Northrop and Boeing. The 2020 election will determine the course thereafter, with military threats and investment arguing for more and deficits driven by rising Social Security and medical costs weighing against. (12/06/19)

17. Defense Budgets to Rise Slightly Through 2021

Contributing Analysts Francois Duflot (Aerospace)

Defense budgets will rise through fiscal 2021, after passage of the Bipartisan Budget Act of 2019, though the longer-term trajectory will be decided by the 2020 U.S. election. The agreement looked to be built out of political expediency ahead of the election, and we expect many in Congress aren't willing to continue incurring large deficits. If Republicans regain control of the House and retain the presidency and Senate, defense spending could rise, though we think more slowly than in the early Trump years, while social-spending growth will be slowed. Conversely, a Democrat-controlled government may limit defense increases in favor of social programs, although we don't expect a centrist to cut dramatically. (12/06/19)

Bipartisan Budget Act of 2019 Limits

	Fiscal Year 2020	Fiscal Year 2021
Security		
Base	666,500	671,500
Overseas Contingency	71,500	69,000
Total	738,000	740,500
Non-security		
Base	621,500	626,500
Overseas Contingency	8,000	8,000
Total	629,500	634,500

Bipartisan Budget Act of 2019
in Millions
Bloomberg

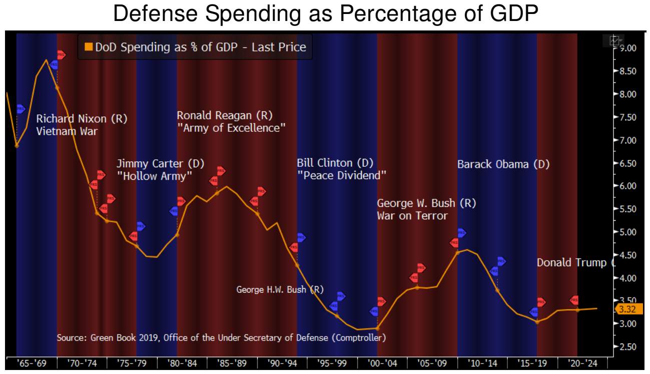
18. Relative to GDP, Defense Outlays Trail Average

Contributing Analysts Francois Duflot (Aerospace)

As defense budgets rise above $700 billion, outlays still feel light. The U.S. allocates about 3.3% of its GDP to defense, less than the post-Vietnam average. While many point to the spending increase during George W. Bush's administration, much of that was on ground forces for operations in Afghanistan and Iraq. Influence and force projection require a strong Air Force and Navy, and both branches are rejuvenating major programs after years of little investment. The larger costs of upgrading ships and aircraft, as well as increased electronic content going into modern military platforms, requires more defense spending.

Spending on aircraft and Navy programs affect all defense prime contractors, especially Lockheed Martin, Boeing, Raytheon, General Dynamics, Huntington Ingalls and Northrop Grumman. (12/06/19)

Defense Spending as Percentage of GDP



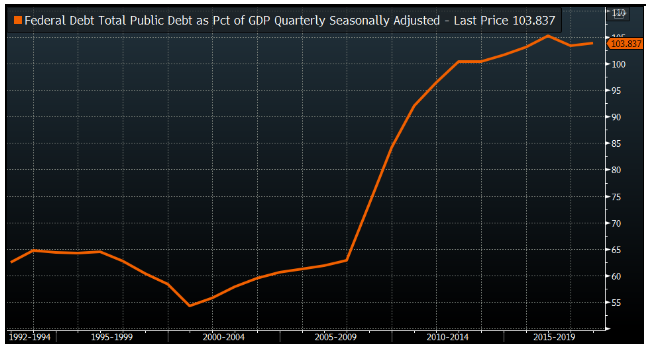
19. Debt, Entitlements to Pressure Defense Budget

Contributing Analysts Francois Duflot (Aerospace)

Rising mandated Social Security, Medicare and Medicaid payments will pressure defense budgets as baby boomers retire, capping the potential for large spending increases without boosting the federal budget deficit and national debt. In the June Long-Term Budget Outlook by the Congressional Budget Office, Social Security payments are expected to rise to 5.9% of GDP from 4.9% over the next decade, and the major health-care programs (Medicare, Medicaid) to 6.7% from 5.2%.

Combined with net interest costs, which are expected to rise to 3% from 1.8%, these programs will consume an additional 3.7% of U.S. GDP, pressuring all federal-government discretionary spending, of which the defense budget is the largest. (12/06/19)

Federal Debt as a Percentage of GDP



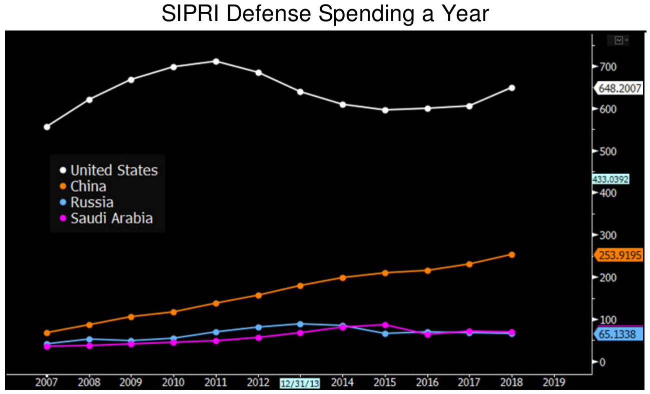
20. Global Dynamics Make Case for More Spending

Contributing Analysts Francois Duflot (Aerospace)

Even as stretched U.S. finances show the need to contain government spending, the global threat environment argues for higher defense budgets. Challenges include increased Russian forward presence as bombers and ships expand global patrols. Official Chinese budgets show gains as the country boosts force projection by adding aircraft carriers to its navy. Meanwhile, challenges from Iran and North Korea persist.

The primary military platforms to counter force projection by competitors include aircraft and ships, the most costly defense programs that need replenishment after decades of spending on ground forces. (12/06/19)

SIPRI Defense Spending a Year



Source: Stockholm International Peace Research Institute

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