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Defense Stocks May Go on the Offensive Again

By CAROLYN WHELAN

For the defense industry, the 1990s will go down as the Decade of Togetherness.

Encouraged by a cost-cutting Pentagon, U.S. defense contractors in the 1990s couldn't get hitched fast enough: Boeing's acquisition of McDonnell Douglas and the merger of Lockheed and Martin Marietta were two of the most prominent combinations.

The wave of mergers coincided with the end of the Cold War and the downsizing of the defense budget by the Clinton Administration. Despite that, aerospace stocks went on a tear through 1998, but some have lost ground since then.

Why? Uncertainties about whether these behemoths could move beyond their dependence on the U.S. Department of Defense; concerns that exports and cross-border mergers could slow because of worries about technology transfer and secrecy issues, and fears of foreign cutbacks in defense spending amid economic weakness made the bulls cautious on the group.

But Robert Nightingale, an analyst at Waddell & Reed, says the sector's recent underperformance could end soon. Even though the earnings growth of defense contractors is much lower than, say, that of technology companies, the contractors should show double-digit earnings increases again, along with faster revenue growth, over the next few years, he says.

"[U.S.] spending is going up, and we're at an inflection point," says Nightingale. "And stocks will reflect that in the next 12 months."

The U.S. defense budget, which was halved between 1990 and 1997, is on the rise for the first time in nearly two decades. This year, for example, President Clinton requested $ 53 billion for procurement, which Congress topped by $3 billion, says Todd Ernst, an analyst at Prudential Securities. And the president's request for $6 billion for Kosovo was nearly doubled to $11 billion by Congress in May.

The push for more defense spending comes just as the U.S. officially has a budget surplus. It's also an election year, and current support for defense spending crosses party lines.

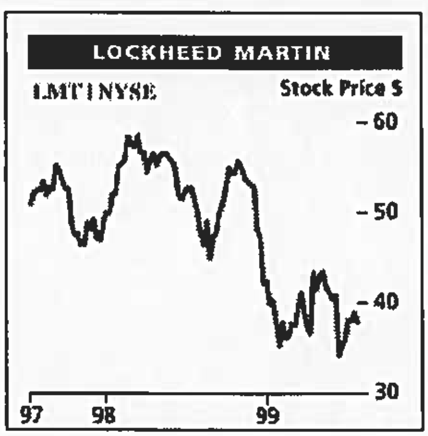
Finally, defense spending is on the rise internationally, and though the Cold War is over, there's lots of instability in the world. "There are rogue states with ballistic missiles," says Ernst, who thinks that could mean higher spending on missile defense. North Korea and China are particular causes for concern, as are Iran, Iraq, India and Pakistan.

Who stands to do well in the current climate? "The overall environment for defense is very positive," says Ernst. "But within defense there [are] definitely winners and losers."

Missiles, missile defense and shipbuilding are likely to get a big boost, the bulls say, and they expect the U.S. military electronics budget to grow at a compound annual rate of 7% over the next decade. That's why a clear favorite is Raytheon, which is strong in both missiles and defense electronics. "[It] probably has the best fundamentals," says Fox.

But some pros are betting on the sector's laggards to catch up.

Nightingale thinks Lockheed Martin (which makes warplanes, missiles and radar systems) and weapons manufacturer Northrop Grumman will benefit as well, particularly from the defense electronics boom.

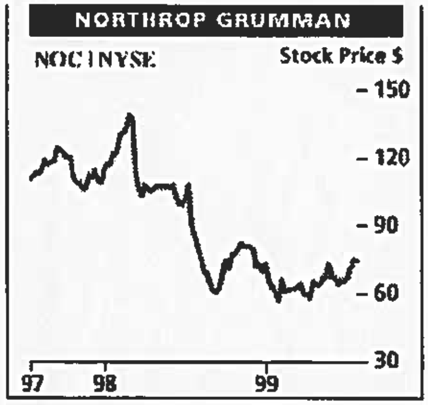


Both certainly have issues to work out. For Northrop, its challenges are its size (its market capitalization is only around $5 billion) and, paradoxically, its reliance on the B-2 Stealth bomber, which is considered the crown jewel of the defense industry. And for Lockheed, earnings problems and shrinking sales of its F-16 fighter are a cause for concern.

But some say a turnaround is at hand for both companies. "The problem children could get their act together, and that will be reflected in the stocks," argues Nightingale. For example, the increased attention to electronic warfare and smart munitions could help Northrop, says Sam Pearlstein, an analyst at ING Barings.

And, of course, both could be

acquired. A merger between British Aerospace and Northrop is a distinct possibility, says John Fox, a money manager at Putnam Investment.



As for Lockheed Martin, "I could see Lockheed doing a major alliance with a European defense company," says Rick Furmanski, a portfolio manager at the Concord Investment Company.

Lockheed management foresees stronger orders in the second half, on orders for the F-16 from Israel and Greece. That's one reason Cai von Rumohr, an analyst at SG Cowen Securities, recently raised his rating on Lockheed Martin stock to Buy from Neutral. Finding a partner for its Comsat telecom unit and selling some smaller businesses like engine control could also enhance shareholder value, he says. And securing funding for the F-22 (the subject of a battle between the U.S. House of Representatives and the Senate) could put the wind back in Lockheed's sails as well.

At Thursday's closing price of 74 13/16, Northrop is almost 20% off its high of 93 -- set in July -- and it trades at 11x projected 1999 earnings and only ten times 2000 estimates. Those multiples are pretty much in line with its 10% long-term earnings growth rate, according to First Call, but are a nice discount to the stock's five-year average P/E of 14x.

Lockheed Martin now trades at 38 1/16, 32% off its 52-week high of 56 1/16. Its P/E of 18x year 2000 estimates of $2.15 a share is at a premium to its long-term projected growth rate of 10%.

Of course, these companies face some risks. "Failure in execution could cost shareholders a lot of money," says Fox. Plus, any downturn in the U.S. economy could cause the projected budget surpluses to evaporate -- along with planned increases in defense spending. And they both may find it hard to make money even on lucrative contracts if they don't cut costs more.

And then there's always the chance peace could sweep the globe, making defense spending unnecessary.

But like the poor, war will likely always be with us in one form or another. So why shouldn't investors profit from it, too?

Return to top of page | Format for printing