GRANT'S
INTEREST RATE OBSERVER®

Vol. 43, No. 2d 233 Broadway, New York, New York 10279 • www.grantspub.com JANUARY 31, 2025

Merchant of deterrence

James Robertson, Jr. writes:

The none-too-numerous tribe of Lockheed Martin Corp. bulls awakened Tuesday morning to watch shares of the country's largest defense contractor slide by a fast 9% on news of a fourth-quarter earnings miss and a downbeat outlook for 2025. The selloff pushes Lockheed (LMT on the Big Board), already a cheap stock, still deeper into value territory. But the losses will likely prove temporary, whereas humanity *will* make war. Nothing has ever stopped it.

Last Thursday, the secretary-general of the North Atlantic Treaty Organization, Mark Rutte, exhorted European members of the alliance to boost their defense spending beyond the current target of 2% of GDP. "I can guarantee you," Rutte told the boldface names in the audience at the World Economic Forum in Davos, "when you look at the incoming data now, 2% is not nearly enough. It will need to be much more, and that will have a huge impact. But we have to do this."

While the inauguration of President Donald Trump bodes well for Western military spending, American defense contractors and their investors are braced for chaos and disruption. Since mid-October, the share price of Lockheed has fallen by 25% while the S&P has risen by 4%. Given the tendency of defense budgets to swell, rather than shrink, and the company's history of beating competitors to the contractual punch, *Grant's* is bullish on Lockheed.

Many are not. The stock trades at 16 times forward earnings and 1.5 times sales and carries a 2.89% dividend yield. Lockheed is a mature, low-growth company that depends on a single customer, the U.S. government, for 73% of its revenue. Beefy defense budgets are bullish. World peace and DOGE are not. Now sole head of the Department of Government Efficiency, Elon Musk called out Lockheed Martin last month for its expensive, ridiculed and much-delayed rollout of F-35 fighter jets.

Some in Silicon Valley see the military as the next industry ripe for disruption. Newer defense companies, like drone-maker Anduril Industries, Inc., are angling to increase their share of the military budget at the expense of the legacy arms-makers. Reduced billings, owing to geopolitical stability or concerns about Lockheed's technical consistency, would squeeze the largest military contractor even further.

Always, the adversary has a say. Neither China nor Russia nor Iran nor North Korea gives reason to expect that human conflict is on the way out. And while upending the taxicab industry is one thing, disrupting the defense industry requires expertise, mass production and discretion that an entrant cannot earn overnight.

Lockheed Martin is the rare business that can lay claim to the appellation "indispensable." In fiscal year 2023, it won $61.4 billion's worth of U.S. government contracts and its closest competitor, RTX Corp., snagged $24.1 billion's worth. Attuned, foremost, to geopolitical cycles, Lockheed also provides some protection against financial ones. It maintains a critical domestic industrial base and employs Americans in nearly every state. Procurement programs extend well beyond initial purchases and include the upgrade and sustainment of vehicles and hardware. Thus, the Department of Defense plans on operating Lockheed's F-35 Lightning II fighters into the 2080s.

Nothing about the armament business is likely to attract a peaceable investor, neither the budgetary politics of organized national violence nor war-making itself. "The development of a military program," Nicolas Owens, industrials analyst at Morningstar, wrote last October, "is long and expensive. A would-be competitor would face material sunk costs from the time spent developing a prototype to pitch for a contract." No wonder that the big six incumbents have tended to scare off or absorb the would-be competition.

Tracing its origins to 1917, the year America entered World War I, Lockheed is responsible for such past and current military hardware as the F-22 Raptor supersonic stealth fighter jet, the SR-71 Blackbird stealth aircraft, the C-130 Hercules military transport and the Trident submarine-launched ballistic missile. Its operations serve all six branches of the American military across four divisions—aeronautics (43% of 2024 revenues), rotary and mission systems (23%), missile and fire control (18%) and space (16%).

Lockheed has begun to recover from the most recent F-35 delays, which have weighed on its aeronautics division. Management delivered 110 fighter jets in 2024 and is expected to ramp up to 156 this year. Missiles and fire control, the fastest-growing division, booked 13% year-over-year sales growth in 2024. Rotary and mission systems was the second-fastest, up 6%. Crowding out these pluses on Tuesday was the consequence of management's decision to recognize $555 million of losses in 2024 on the expectation of higher future costs in its classified pipeline: Full-year 2024 earnings dropped by 23% from the $6.9 billion in 2023.

Details were sparse concerning the advanced development unit—hush-hush was the word—but management pitched the charges as a significant "derisking." On the earnings call, Chief Financial Officer Jay Malave called it the "most conservative assessment we've made to date" and guided for a return to sales and earnings growth in 2025. During the prior Republican administration, sales and earnings climbed at the compound annual rates of 12% and 18%, respectively.

"How is the U.S. Department of Defense budget going to evolve?" Matthew Woodruff, head of defense and aerospace research at CreditSights, asks, and he answers: "I think it's going up. I don't think it's going down. I think there are significant investments that are going to be prioritized relative to the ability to wage war in the Pacific region. And this, by far, is the biggest priority. It's aerial. It's naval capabilities that will allow the United States to wage war in Asia, and they are going to be super important, and that stuff is expensive."

Past is no prologue, but under Trump's first administration, defense spending grew cumulatively in nominal terms by 20%, or by 3% annually in real terms, according to Bloomberg. Republican priorities, enumerated in the 2024 party platform—further investments in stockpiles, modern weaponry, production and the development of an American Iron Dome—would buoy Lockheed's top line if Congress and the president enacted them. Upwardly revised spending targets for NATO allies would do the same since American contractors produce the most advanced armaments.

Lockheed's missiles and aircraft have topped the shopping list of the Ukrainian military since the Russian invasion began. Javelin anti-tank launchers, HIMARS (High Mobility Artillery Rocket Systems), Patriot (Phased Array Tracking Radar to Intercept on Target) air-defense interceptors and F-16 fighters were force multipliers on the Eastern European battlefield. As of the end of 2024, Lockheed's backlog for new orders from American and allied militaries reached a record $176 billion.

Yet current stockpiles are not enough to meet the burdens of modern warfare, the new chairman of the Senate Committee on Armed Services, Roger Wicker (R., Miss.), warned last year. He revealed that many munition production lines operated at the minimum sustaining rate or at some small fraction of total capacity. A single carrier group in a nine-month deployment to the Red Sea expended some 3% of the U.S. Tomahawk missile arsenal, the Heritage Foundation estimated last August, and most were used in a single day.

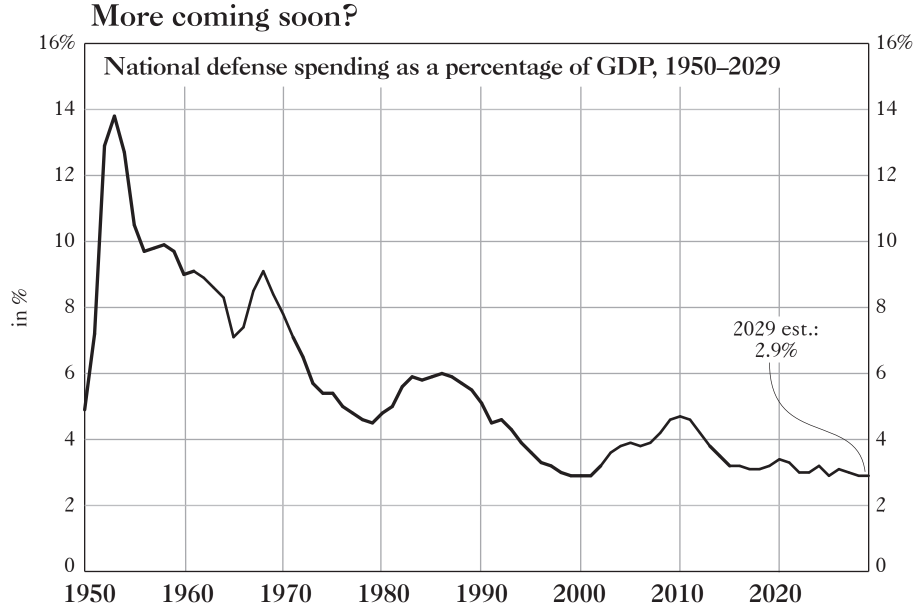
In the event of a U.S.–China war in the Taiwan Strait, the Center for Strategic & International Studies estimated two years ago, the United States would probably fire more than 5,000 missiles in the first three weeks of fighting. The majority of the missile variants that analysts cited were manufactured by Lockheed, including joint air-to-surface standoff missiles and long-range anti-ship missiles. For fiscal year 2025, the Department of Defense requested 775 of those missile types, a 4% increase over fiscal year 2023.

On the aviation front, the F-35 Lightning II is king for Lockheed. It is one of, if not the, most complex defense-development program in history and responsible for 26% of the company's top line. In 2001, the U.S. government selected Lockheed Martin to create a new fighter jet, with three separate variants for the Air Force, Navy and Marines. But the F-35 program reached full-rate production only in March of last year, after numerous delays, foul-ups, redesign requests and modernization updates. Projected costs spiraled to $2 trillion last year, up from $1 trillion in 2015.

After a year-long pause relating to the most recent technology upgrade, Lockheed resumed deliveries of the F-35 last July and later announced a handshake agreement on the next lots, Nos. 18 and 19. In November, Romania became the 20th country to place orders for the F-35, contracting to buy 32 of the stealth fighters with a reported radar signature of a golf ball. "What we have got today once all the software updates are complete," Woodruff relates, "is a tremendously powerful technology platform up there, capable of doing things that no other vehicle can do. It's extremely aware of the battlefield situation."

And the American military is in sore

More coming soon?



source: White House Office of Management and Budget need of an update. The average age of Air Force fighter planes, a fleet largely developed in the 1970s and 1980s, is 28. "The Air Force is now the oldest, smallest and least ready it's ever been in its history," David Deptula, retired lieutenant general of the branch and now dean of the Mitchell Institute for Aerospace Studies, asserted on a Dec. 7, 2024 episode of the podcast *Aerospace Advantage*. "Today, the F-35 is the most effective affordable option [for the U.S. military] to get to both capability and capacity."

While new drone manufacturers such as Red Cat Holdings, Inc. (RCAT on the Nasdaq) have grabbed headlines, manned aircraft are not likely to be phased out any time soon. Drones are susceptible to enemy jamming and takeover. Long-range flights, particularly in contested airspace, require a human behind the yoke, Deptula said.

Integration of drones and fighters, instead, has become a focus of DoD, and Lockheed has developed systems that will allow F-35 pilots to "quarterback" drones from inside the cockpit. Lockheed is well ahead on sophisticated drone production, Steven Bogden, an investment and geopolitical strategist, tells me. For big-ticket items like intricate aerial and underwater drones, the proven contractors have a competitive advantage, and Bogden believes that contracts of that complexity will go to incumbents like Lockheed.

"At one point, part of me was thinking, this is a sort of watershed moment for the industry: a lot of private equity money and venture capital money flowing into defense startups," says Michael Ciarmoli, managing director of aerospace and defense research at Truist Securities. "But it's not a free market. You've got one main customer. I wouldn't underestimate these big, legacy defense prime contractors. I can't envision any startup standing up a global or even national production supply chain that spans 50 states."

A high-tech business in its own right, Lockheed trades at a price-earnings multiple 31% below the average logged by industrial equities in the S&P. Its solid financial footing today follows from its creditors' conviction that, not unlike Citibank or JP Morgan Chase & Co., it won't be allowed to disappear. Thus, it borrows cheaply and at long maturities. The A-minus-rated issuer carries net debt equivalent to 2.1 times trailing 12-month Ebitda. For that leverage, Lockheed pays a weighted average fixed coupon of 4.62% at a weighted average maturity of 17.4 years. Ebitda covers interest expense by 8 times.

Nor are equity investors overly bearish. Short interest on Lockheed shares registers at 1.2% of the float. On Wall Street, 12 analysts say buy, one says sell and 15 retain their neutrality. In the past six months, insiders have sold a net 3,272 shares for proceeds of $1.8 million.

With a record backlog of deeply intwined connections with the pre-Pete Hegseth Department of Defense and its allies, Lockheed will not be easy to unseat. The president wants to get rid of the debt ceiling and rebuild the military, so a new cycle of defense spending may be in store. Defense outlays, measured as a percentage of GDP, have tumbled to 3% in the latest fiscal year from 11.3% during the Korean War. A new upcycle would surely redound to the benefit of the indispensable Lockheed Martin.

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