Seeking Alpha
**Transcripts** | **Industrial**

# Huntington Ingalls Industries, Inc. (HII) CEO Michael Petters on Q3 2019 Results - Earnings Call Transcript

Nov. 7, 2019 2:26 PM ET
by: SA Transcripts

Q3: 11-07-19 Earnings Summary

*Press Release* *Slides*

EPS of $3.74 beats by $0.11 | Revenue of $2.22B (6.53% Y/Y) beats by $18.81M

---

## Earning Call Audio

Subscribers Only

00:00 -52:29

Huntington Ingalls Industries, Inc. (NYSE:HII) Q3 2019 Earnings Conference Call
November 7, 2019 9:00 AM ET

**Company Participants**

Dwayne Blake - Corporate VP, IR

Michael Petters - President, CEO & Director

Christopher Kastner - EVP, Business Management & CFO

**Conference Call Participants**

Carter Copeland - Melius Research

Caius Slater - Bernstein

Myles Walton - UBS Investment Bank

Jonathan Raviv - Citigroup

Jeffrey Molinari - Cowen and Company

George Shapiro - Shapiro Research

Robert Spingarn - Crédit Suisse

Peter Skibitski - Alembic Global Advisors

David Strauss - Barclays Bank

Joshua Sullivan - Seaport Global Securities

Noah Poponak - Goldman Sachs Group

**Operator**

Ladies and gentlemen, thank you for standing by, and welcome to the Third Quarter 2019 Huntington Ingalls Industries Inc. Earnings Conference Call. [Operator Instructions]. I would like to hand the conference over to your speaker today, Dwayne Blake, Vice President, Investor Relations. Please go ahead, sir.

**Dwayne Blake**

Thanks, Michelle. Good morning, and welcome to the Huntington Ingalls Industries Third Quarter 2019 Earnings Conference Call. With us today are: Mike Petters, President and Chief Executive Officer; and Chris Kastner, Executive Vice President, Business Management and Chief Financial Officer.

As a reminder, statements made in today's call that are not historical fact are considered forward-looking statements and are made pursuant to the Safe Harbor provisions of federal securities laws.

Actual results may differ. Please refer to our SEC filings for a description of some of the factors that may cause actual results to vary materially from anticipated results. Also, in their remarks today, Mike and Chris will refer to certain non-GAAP measures. Reconciliations of these metrics to the comparable GAAP measures are included in the appendix of our earnings presentation that is posted on our website.

We plan to address the posted presentation slides during the call to supplement our comments. Please access our website at huntingtoningalls.com and click on the Investor Relations link to view the presentation as well as our earnings release. With that, I'll turn the call over to our President and CEO, Mike Petters. Mike?

**Michael Petters**

Thanks, Dwayne. Good morning, everyone, and thanks for joining us on the call. Let me share some highlights from the quarter starting on Slide 3 of the presentation. Sales of $2.2 billion for the quarter were approximately 6.5% higher than 2018, and diluted EPS was $3.74. New contract awards during the quarter were approximately $2 billion resulting in backlog of approximately $39 billion at the end of the quarter of which $17.8 billion is funded.

Turning to capital deployment for a moment. Earlier this week, we announced that our Board of Directors approved a 20% increase in our quarterly dividend from $0.86 per share to $1.03 per share. We also increased our share repurchase program from the most recent authority of $2.2 billion to $3.2 billion and extended the term from October 2022 to October 2024. These decisions demonstrate continued confidence in the free cash flow generation of the business that supports our path to 2020 commitment to return substantially all free cash flow to our shareholders.

Regarding activities in Washington, we are encouraged that the House and Senate are conferencing the National Defense Authorization Bill and are hopeful that a timely conference agreement will be produced for fiscal year 2020. We are very pleased with strong support for shipbuilding by the Senate Appropriations Committee, which included funding for surface combatants, submarines, amphibious warships, aircraft carriers and autonomous platforms. In particular, acceleration of both LPD-31 and LHA 9, the fiscal year 2020 will best leverage the high production lines and supply chains for amphibious warships and incremental funding will permit the Pentagon to efficiently balance investment for these ships across the future years defense plan. While the government is currently operating at our continuing resolution through late November, we continue to urge the Congress to pass final appropriations measures as quickly as possible.

Now let me share a few business segment highlights from the quarter. At Ingalls, the team achieved completion of external structural work on NSC 9 Stone in July and the ship was launched in early October. Cost performance remains in line with our expectations and the ship is anticipated to be delivered late next year. DDG 119, Delbert D. Black, continues to recover from the impact of the incident earlier this year and is planned to be delivered in the first half of next year. LPD 28, Fort Lauderdale performance remains favorable and the next significant milestone for this ship is launched, planned for the first half of next year. And on LHA-7 Tripoli, the team recently completed acceptance trials and is on track for delivery in late 2019 or early 2020. At Newport News, CVN 73 USS George Washington was undocked at the end of September and moved to an outfitting birth where final outfitting and testing activities will be performed. The refueling and complex overhaul is now more than 60% complete and the ship is expected to be redelivered to the Navy in late 2021.

CVN 79 Kennedy is on track for launch, starting with flooding the dry dock and floating the ship last week. The team is preparing to ship for her christening ceremony on December 7 and planning for exit from the dry dock by the end of the year. That ship is approximately 67% complete and performance remains in line with our expectations. On the submarine program, SSN 791 Delaware delivered in late October and SSN 794 Montana, our first Block IV delivery remains on track to achieve the pressure hull complete milestone next month with delivery planned for the first half of 2021.

And finally, the Block V contract is on track for award by the end of this year. This is an exciting and extremely productive time for our shipbuilding teams. Over the past month or so, we have undocked CVN 73 USS George Washington, delivered SSN 791 Delaware, completed acceptance trials on LHA-7 Tripoli, started the process for launch of CVN 79 Kennedy and completed sea trials for the post-shakedown availability and redelivered USS Gerald R. Ford to the Navy. All of these activities demonstrate an operating rhythm that supports achieving shipbuilding operating margins of 9% to 10% in 2020. And regarding the Ford, completion of sea trials is another step towards completing the most complex Navy ship ever produced. The manufacturing of this ship incorporated numerous new technologies and systems, including the advanced weapons elevators and these technologies performed well on the recent sea trials. This is both exciting and rewarding. I have spoken directly with both Secretary Spencer and Assistant Secretary, Geurts and we are aligned on the plan to get the ship ready for deployment as soon as possible. We have a great team that includes Newport News Shipbuilding, the Navy and other industry experts and I am confident that our collective efforts on Ford will bring superior capability to the Navy and to our nation for decades to come.

In our Technical Solutions segment, the team performed well across the portfolio, focusing on execution of existing contracts while capturing new business awards to help set the stage for growth. For example, TS continue to provide critical support to the Department of Energy through multiple contracts at the Savannah River, Los Alamos and Nevada nuclear site. And is pursuing additional opportunities for growth in the DOE and nuclear markets. Along with their bowing teammate, TS began to ramp-up production of XLUUV, the Navy's flagship UUV program that has significant potential for long-term growth. Aside from XLUUV, TS is also pursuing several other critical new programs in the unmanned undersea and unmanned surface vehicle markets. And TS also recently won a large number -- won a number of large multiple-award contracts that provide new opportunities for growth, including a Defense Intelligence Agency contract to provide analytic and operational support services to maintain global situational awareness of threats to our nation and our allies. A NAVWAR contract to provide a float C4ISR installation services and a contract to provide network architecture and cybersecurity services to the U.S. Air Force.

Overall, Technical Solutions performance in the quarter was solid, and the team remains positioned to achieve low single-digit top line growth and 5% to 7% margin in 2020. In summary, I am encouraged by the Senate Appropriation Committee's recognition of the need to leverage the high production lines and supply chain for amphibious warship, and I am very pleased with the shipbuilding results that create a path to achieve -- to achieving 9% to 10% shipbuilding margin in 2020. I am also very pleased with the progress being made on multiple fronts by our Technical Solutions segments, we are taking the right steps to position the company for the future and our team is laser-focused on efficiently executing our significant backlog in order to drive long-term sustainable value creation for our shareholders, our customers and our employees. And now I will turn the call over to Chris Kastner for some remarks on the financials. Chris?

**Christopher Kastner**

Thanks, Mike, good morning. As I review our third quarter financial result, you may follow along with the slide presentation we posted this morning on our website. Beginning with our consolidated results on Slide 4 of the presentation, our third quarter revenues of $2.2 billion increased 6.5% compared to the same period last year primarily due to growth in our Technical Solutions division due primarily to the acquisitions of G2 and Fulcrum and higher volumes in Aircraft Carrier and submarine programs at Newport News. Operating income in the quarter of $214 million decreased $76 million or 26.2% from third quarter 2018, an operating margin of 9.6% decreased 428 basis points. These decreases were primarily driven by a lower operating FAS/CAS adjustment compared to the prior year as well as lower segment operating income. Primarily due to a $43 million benefit at Newport News related to workers' compensation in the third quarter of 2018, partially offset by contract changes in the current period for submarine fleet support services.

Turning to Slide 5 of the presentation. Cash from operations was $363 million in the quarter, and net capital expenditures were $113 million or 5.1% of revenues compared to cash used in operations of $93 million or $102 million of net capital expenditures in the third quarter of 2018. Through the third quarter, net capital expenditures totaled $278 million. We expect the capital expenditures for the full year will be approximately 5% of sales.

During the quarter, we contributed $25 million in our pension and postretirement benefit plans, of which $16 million were discretionary contributions to our qualified plans. We also repurchased approximately 322,000 shares at a cost of $68 million and paid dividends of $0.86 per share or $35 million, bringing our quarter-end cash balance to $32 million. At quarter end, we had $264 million outstanding on our revolving credit facility.

Moving on to Slide 6 of the presentation. Ingalls revenues in the quarter of $647 million decreased $47 million from the same period last year due to lower volumes on the NSC and LHA programs. Ingalls' operating income of $61 million and margin of 9.4% in the quarter were down from third quarter of 2018, mainly due to lower risk retirement on the NSC program.

Turning to Slide 7 of the presentation. Newport News revenues of $1.3 billion in the quarter increased 7.2% from the same period last year, mostly due to higher volumes in aircraft carrier and submarine constructions. Newport News operating income of $109 million and margin of 8.6% in the quarter were down year-over-year, primarily due to a workers' compensation benefit of $43 million in the same period last year.

Now to Technical Solutions on Slide 8 of the presentation. Technical solutions revenues of $347 million in the quarter increased 41.6% from the same period last year, mainly due to the acquisitions of G2 and Fulcrum, which collectively contributed $59 million of revenue in the quarter as well as growth in fleet support in oil and gas services revenues.

Technical Solutions operating income of $21 million in the quarter compares to operating income of $16 million in the third quarter of 2018 primarily due to improved performance on nuclear and environmental contracts.

Turning to Slide 9. We've updated our 2019 and 2020 pension and postretirement benefits outlook. Our 2019 projected CAS expense has declined by $20 million from $298 million to $278 million with no change to our projected FAS expense. This decrease is driven primarily by an update of actuarial estimates resulting from updated demographic and economic assumptions.

Projected 2020 total CAS expense has increased by $169 million from our initial outlook to $445 million, primarily due to lower discount rates in 2019, partially offset by an anticipated favorable return on assets in 2019.

Consequently, the 2020 FAS/CAS adjustment has also increased from the prior outlook and is now projected to be $276 million for the year. Additionally, our expected 2020 cash contributions have increased by $79 million from our initial outlook to $252 million, of which $216 million is discretionary contributions to our qualified plans. The increase in the cash contribution is primarily due to the lower discount rates.

The 2020 projections provided on Slide 9 are based on data as of August month-end, including a FAS discount rate of 2.32%, which has fallen by 111 basis points since our update in February and assumes 2019 asset returns of approximately 14%. Please remember that pension-related numbers are subject to year-end performance and measurement criteria. We will provide updated pension estimates for 2020 and 2021 on our fourth quarter earnings call in February.

Finally, we continue to expect that our shipbuilding business will achieve approximately 8% return on sales for the full year and remain confident that margins will ramp to 9% to 10% in 2020.

That concludes my remarks. I'll turn the call back over to Dwayne for Q&A.

**Dwayne Blake**

Thanks, Chris. [Operator Instructions]. Michelle, I'll turn it over to you to manage the Q&A.

**Question-and-Answer Session**

**Operator**

[Operator Instructions]. Our first question comes from the line of Carter Copeland with Melius Research.

**Carter Copeland**

Mike, I wondered if you could talk a little bit about BCS Block V and the progress there, moving towards the contract. Obviously, the -- it looks like the cost per boat is a little bit higher than originally planned and I think that impacted the quantities. But I wondered if you might give us some color around what that means for the risk profile there versus what you've kind of talked about in the past? Any color there would be helpful.

**Michael Petters**

Yes. I think it's a good question. We're at the point now in the process where we really need to go to contract. And we've been working very hard with our partners at General Dynamics and with the Navy to fashion a contract that makes sense of the authorization that's out there, the appropriation that's out there and where we see the challenges in the business are going to be. And so I think we're on track for that. And as we said, we're going to -- we're heading to get to a contract by the end of the year. My personal view is that I think, the authorizers have been pretty clear that the more submarines, no matter how many submarines we have, we're going to want more. And I think that the appropriators have tried to balance that with the other priorities that they have. And as a result in our contract negotiations with the Navy, we've worked hard to make sure that we provide good value for the contract. And I think that we're going to create a contract here that's going to have -- that's going to be able to address all of that.

**Carter Copeland**

Great. And then as a follow-up, Chris, I wondered if you might just give us the EACs for the quarter?

**Christopher Kastner**

Yes. Sure. The adjustments -- or the cume adjustments for the quarter, gross favorable were 64%, gross unfavorable were 20%. So it's a net of 44%. Of that net, 35% of that was Ingalls, 45% was Newport News, and TS was 20%.

**Operator**

And our next question comes from the line of Doug Harned with Bernstein.

**Caius Slater**

It's Caius Slater signing in for Doug. So Mike, in the second quarter, you said you'd ask the business leaders to look again at execution and risk management to see if there is any opportunities to improve on that. Just what have they found? What are the challenges? Where are the opportunities? I think, previously, you've talked about eliminating hiccups in execution, but what are the more sort of structural things that you can look at?

**Michael Petters**

That's a good question. We did sort of go back and do a deep dive into this and try to understand why parts of the business, there are pockets that were handling execution really well, and there were pockets that weren't and we had some inconsistencies there. And so what we're doing at this point is, we're expanding and basically developing a comprehensive operating system that would be the standard protocol for all of the programs that we have in the company. And it's kind of interesting to think that you can have a structure, but then when it gets all the way to the waterfront, it starts to move around a little bit. And so we're going to put some more discipline and scratch into that. And we're on track for it.

**Caius Slater**

That's great. And then just a quick follow-up on Technical Solutions. The business is there, they appear to be very diverse. So how do you fit all those together? And how do you manage that across a range of customers and service offerings?

**Christopher Kastner**

Our general operating model in the organization is that we delegate as much authority to the divisions as we can. We want to make sure that the authority and accountability is distributed so that when the divisions are facing their customer, they have the authority to do -- to make the decisions they need to make to support that customer, but with that goes the accountability to get it right. That's the case in shipbuilding and that's the case in Technical Solutions too. Regarding the operating system kind of, in general, the -- you can imagine this becomes here, all the perimeters that we need to consider and include in our -- in how we operate and support a customer. And then in details with the customer, there would be okay. That make sense for this one, that one, we probably need to go deeper on. Here is one that doesn't speak very well to this customer and so we have to work our way through that. Actually, the TS guys do pretty well with that right now, as you can see. And so I don't think it's going to be that hard to bring that -- create an overarching structure for.

**Operator**

And our next question comes from the line of Myles Walton with UBS.

**Myles Walton**

Mike, I was wondering if you could talk about some of the post-delivery liabilities that still exist on the Ford. And maybe at a higher level, talk about warranties versus guarantees for shipbuilding. And in particular, how if at all that's changing going forward with maybe the frigate being one of the experiments?

**Michael Petters**

Yes. So that's a really complex set of questions there, Myles. So the -- I think that most of the news has been recently around the Ford and how that pertains. There comes a point in time in these ships, where it becomes important for the Navy to begin to operate. I mean, if you think of the aircraft carrier is a city of 5,000 people with all of the functions that go on in the city, including its own airport, there comes a point in time where the city has to operate even if there are things that still need to be done. And so that's how you get to a delivery of the ship to let the Navy go operate it. In the course of that, there's stuff that comes up that we need to go back and work on.

Our contract arrangements allow us to engage with that and pursue it. The normal track for the delivery of a ship is the ship will deliver, the Navy will go operate it for a while. It will come back to the shipyard for a post-shakedown availability. In the case of a lead ship, especially the case of the Ford, where you are developing. A lead ship is not -- it's not an incremental change in technology. It's usually 3 or 4 generations of change in technology. And so as you try to accommodate and develop those new technologies and move them into a production environment, you have to be agile and flexible on how you're going do balance that with the need for the Navy to operate the ship. So that's the way that we have proceeded across the whole range of technologies that we have out there. Some of that work will continue under the base construction contract. Some of that work, if it's complete, will be then covered in case of a warranty. And some of that becomes new scope and becomes a contract change. And it all just depends on the maturity of the technology and the item that we're talking about.

**Christopher Kastner**

Yes. I don't want to -- Myles, this is Chris. I wouldn't comment specifically on the frigate because it is competitive, but we generally don't see a material amount of post-delivery liabilities on the ships at delivery. There are obviously things that have to be worked off. We generally or always include those liabilities within the EACs and within our booking rates in our contracts.

**Myles Walton**

Great. That make sense. And Chris, maybe, while I have you, the cash flow walk into next year into 2020, I know, obviously, I'm not asking for cash flow guidance, but the CapEx that trends toward the 4% range into next year. And it sounds like the net effect of pension is effectively a neutral year-on-year. Are those 2 moving parts, right?

**Christopher Kastner**

Yes. No, thanks for that and thanks for not asking for guidance on 2020. But yes, the last high year related to capital is next year, and I'll give an update related to pension for 2020 as well because there was a pretty significant move there in our updated estimate. But you've got it about right. And we'll provide an update in all of those factors on our year-end call.

**Operator**

And our next question comes from the line of Jon Raviv with Citi.

**Jonathan Raviv**

Chris, just following up on that cash question, maybe I'll include the other year also. Is it still fair to think about 2019 being modestly above last year? Or is pension going to impact that? And can you just clarify in 2020 you said, 2020 is the high year on capital, so we should not expect CapEx release next year?

**Christopher Kastner**

Yes. So still north in 2019 where we finished last year, which was $512 million. That being said, there is always plus or minus $50 million to $100 million related to working capital that can show up here in the last week. And what was the 2020 question, again?

**Michael Petters**

Capital.

**Christopher Kastner**

Capital, yes. So capital, it's $1.8 billion to $1.9 billion for the 5 years. So still a high level of capital in 2020. And then we get back down to the 2.5% of sales in 2021.

capital in 2020. And then we get back down to the 2.5% of sales in 2021.

**Jonathan Raviv**

Okay. Got you. And then just as a follow-up, just your perspective on running pretty tight cash balances for the past few quarters, you have some big moves in the revolver. And now working capital can be a big swing item. What's being held out and when should we expect some releases? How much of this is Block V? And when we get that release, can we see some more aggressive repurchasing since repoised down year-on-year. All those shares are flat year-on-year, on maybe the carrier deal signed here. So just sort of overall question on cash balance and what it takes to really some of that?

**Christopher Kastner**

Yes. So we're not overly concerned with our cash balance. We have adequate capacity within our commercial paper program. So we're really comfortable where we are from a cash standpoint. We have line of sight on all of the invoices that we're managing to get to year-end. So that's slightly north of last year we're pretty comfortable with. Of course, working capital can move it around a little bit. Relative to share buyback, we are actually comfortable with the commitment we made in '15 to return substantially all our free cash flow back to shareholders. We've increased our dividend at least 10% annually and executed the share buyback program that has us as over 120% return. So we're comfortable with that strategy. We're going to continue it, and we'll just move on from here.

**Operator**

And our next question comes from the line of Gautam Khanna with Cowen and Company.

**Jeffrey Molinari**

This is Jeff Molinari on for Gautam. So I'd like to adjust ask about Virginia-class performance. Can you talk a little bit about how you're performing versus schedule and cost? And kind of what challenges you've seen on the program or where are you kind of on the learning curve? Any color would be helpful.

**Michael Petters**

Yes. That's a good question. A lot of complexity in that question. Some of the challenges that have come up with Virginia-class was where we expanded the production rate from 1 submarine a year to 2 submarines a year. That required -- requires workforce enhancement and development. We fought through some challenges regarding sequester on the front-end of that program, which handicapped I think the program some. We had to -- you may recall, we had to go through some personnel reductions in Newport News before we had to start back into the program.

We also were coming out of the block. It took a long time to negotiate the contract and we're probably a little slow to buy material, which -- that also affected the schedule. But what's happening in the program today, that's kind of a coming out of the block, the start a gun went off. And I'm not sure we were at sprint speed at the very beginning. But where we are today is, we're actually ramping right into that production rate. We're seeing tremendous learning in our teams. The teams are mature. We've invested in facilities to expand their capacity and we've reflected that as we've gone to negotiate the Block V contract. So I'm pretty comfortable with where we are on the submarine program today. We went through a little bit of a tough period there with all of those moving parts, but I think we're on -- that's behind us at this point. And now it's just a matter of going out and prosecuting the learning curves and continuing to prove on that every single day.

**Jeffrey Molinari**

That's very helpful to hear. One other quick follow-up, if you don't mind. Can you walk through to switching gears? Can you walk through some kind of key upcoming risk retirement milestones in Q4 and I guess, early 2020 ending on the horizon?

**Michael Petters**

Well, the previous milestones we provided in Q2 for 2019 are all on schedule. We expect those to happen over the balance of the year and we'll provide an update for 2020 on our year-end call.

**Operator**

And our next question comes from the line of George Shapiro with Shapiro Research.

**George Shapiro**

One for you, Chris. Was the contract adjustment in Newport News for the Los Angeles class, is that one time? Or is that part of the EACs? And roughly was the magnitude, maybe $20 million?

**Christopher Kastner**

I won't comment specifically. It wasn't material enough to comment on in the quarter, but it was Helena in Q3.

**George Shapiro**

No. But, I mean, you put in the race, so I figured it must be something substantial saying it partially offset the workers' comp benefited from last year.

**Christopher Kastner**

Well, it was enough to mention, but it wasn't enough to mention the value, George. We did adjust the EAC for it. And it'll -- on a going-forward basis, obviously the booking rate would be better on that program.

**George Shapiro**

Okay. And then for you, Mike. Just to follow-up on Block V. So the Navy is implying that they're only going to have the 9 ships rather than 11 or so. If you could just go through, I mean, it's cost, I assume evidently, and I know you talked about it a little bit earlier in the call, but I don't think you touched on it specifically?

**Michael Petters**

Well, we're still working our way through getting that contract. So I think I want to talk less about the specifics of that contract. We expect that to be done by the end of this year. And the shape of that contract I think will be a good balance for all of the folks that are interested and involved in it. I think that the most important thing from my standpoint is that the early on challenges in Block IV, we think are a really behind us, and we're moving ahead. And that sets up Block V very well for us.

**Operator**

And our next question comes from the line of Robert Spingarn with Crédit Suisse.

**Robert Spingarn**

I just wanted to follow-up with a couple of carrier questions, guys. We'll start with Chris. Just on the risk retirement so you just alluded to. Can you just give us a sense of we fully reflect the risk on 79? When you float the ship here in the second half? There's all the potential EAC upside there happened in Q4 to some of that slip into next year? And then I have a follow-up for Mike.

**Christopher Kastner**

That's a good question, Rob. I think you're going to evaluate the risk every quarter, obviously. And as you get to launch, you're going to evaluate some risk. But they're going to -- they have a lot of risk in front of them. So there are risk retirement milestones on 79 in 2020 as well related to the test program. So, it's a Q4 issue and it's a next year issue.

**Robert Spingarn**

Is the majority Q4?

**Christopher Kastner**

I would say there is more risk in 2020 than in 2019.

**Robert Spingarn**

Okay. And then Mike on the 78 on the Ford, and with regard to shock trials, where do we stand on this? And if there is -- if it fails the shock trial, how do you frame the potential implications for the other Ford-class ships?

**Michael Petters**

Well, shock trial is still part of the cycle between where we are today and where the shape would go to its initial full-scale deployment. The question you've answered -- you've asked about what happens, there is a whole lot of data taken during the shock trial that has to be analyzed. It's almost you have to kind of say what kind of assumptions do you want to make. It's not really going to be a case of the ship passed or failed the shock trials. It's really going to be on a frame-by-frame, component-by-competent, how did the ship react to the shock and then is that okay, or is there something that we're going to be required to do to make it better. And that's part of the process. We've been through these before and there is a pretty well-understood process for getting the ship ready for the trial, executing the trial and then analyzing the data and recovering it from the trial and getting onto deployment. I would just point out that typically, the trial is not done on the lead ship, the trial is done on the second or third ship of the class to allow the maturity to go into place. So this is unique. But that's okay. We'll -- whatever path the Navy wants to go down, we're happy to be a partner with them and assist them along that path.

**Robert Spingarn**

But if you do have to do one on the lead ship, again, it sounds like you then might be making more changes than you normally would have to if you didn't on the second ship?

**Michael Petters**

I don't know how to handicap that quite frankly. The change over the change from the lead ship to the follow-on ships are not usually in the whole mechanical or electrical places and they're going to be more in the component system places. And so I don't know how to really kind of broad-brush that one.

**Operator**

And our next question comes from the line of Pete Skibitski with Alembic.

**Peter Skibitski**

Mike, there were some news in the trade press that there's, I think 6 carriers docked at Norfolk right now. I don't really know the reasoning behind it, but maybe you can give us a sense of the carrier maintenance work that could result from that and maybe the outlook for ship maintenance in general.

**Michael Petters**

Let me start with the second one first. The overall outlook for ship maintenance is that there's more maintenance to be done than there is really capacity right now in the system to do it. And so the Secretary, the Assistant Secretary, the CNO, the industry have been working hard to try to figure out how do you get more readiness per dollar because maintenance translates into readiness in terms of language.

How do you get more maintenance? How do you get more readiness per dollar in the next period of time? And there's been some creativity brought to, maybe we contract a little bit differently, maybe we bundle contracts, maybe we do more planning, lots of those kinds of ideas that are being talked around at the working level that frankly, are coming from the secretary's push for, let's get this right. And to the Navy's credit, they've gone out and they've looked at other industries that have large fleets, and they've asked them how do they do it. So -- and we're deeply involved in that discussion with the Navy on how can we support that. Relative to the carriers, I think, the carriers are part of that discussion. And in a couple of those cases, we are assisting in helping get the Navy -- helping the Navy through this little bit of a crunch to get ships in a place where they can deploy. We're first ready to help them in any way we can.

**Peter Skibitski**

Okay. Just one quick follow-up on the CR. I guess, I think that tech services is kind of your short-cycle business and we're in November. Is tech services kind of feeling that CR at all right now in Q4? And how do you think about the impact overall to HII, if it goes into February or so?

**Michael Petters**

Yes. So we're not seeing anything yet. If it moves into Q2 next year, it could become an issue. But we're not seeing any impact as of yet.

**Operator**

And our next question comes from the line of David Strauss with Barclays.

**David Strauss**

I wanted to ask about the 8% shipbuilding merger and guidance for 2019. If I do the math there, it looks like you're assuming relatively flat sequentially Q4 versus what you just put up in Q3. Can you just touch on that, it wouldn't seem like you've got more opportunity from a milestone perspective given kind of what came through in October and so what's out there to potentially do better than that.

**Christopher Kastner**

David, this is Chris. And we look at everything out there. 8% still makes a lot of sense to us. That being said, we'll assess all the milestones. We'll assess all the ACs in Q4 and adjust accordingly. But we're still comfortable with that 8%.

**David Strauss**

Okay. And Mike, did I hear on Montana, did that slip versus what you had said previously. I thought we are looking at 2020 on that, but I think on your prepared remarks, you said first half of 2021 now?

**Michael Petters**

Did I say that?

**Christopher Kastner**

Yes.

**Michael Petters**

Yes.

**David Strauss**

Okay. So it did slip?

**Christopher Kastner**

Yes. That's right. I mean, we got a pressure hull complete this quarter and then Mike indicated, it will slip.

**David Strauss**

Okay. And then the last one for me, I think this is fair since you talked about before Chris, you had said 2021 we could think about free cash flow pretty close to 100% conversion. Is that still a good place to think about, I guess, particularly now looking at what CAS is at least doing in 2020. I know, we're not talking about 2021 here, but just your prior comment on '21 free cash flow conversion.

**Christopher Kastner**

I think that's fair, David. I think that's a good way to think about it. All the factors that have been somewhat nonrecurring in nature or winding down here with capital and the net pension slowing down a little bit. And then becoming normalized a bit -- from -- and stabilizing working capital you would think that a 1.0 cash conversion is what we should achieve. That being said, at the end of the last year, $100 million to $150 million received in last week, which was great for everyone, but it was an expected benefit in '18 that we've been crawling out of in '19 over the last 3 quarters to achieve good cash here this year.

**Operator**

And our next question comes from the line of Josh Sullivan with Seaport Global.

**Joshua Sullivan**

What are the thoughts on the upcoming for the structure assessment at this point? Potentially looking at a little more distributed architecture, do you see opportunities there? Just what are some of the puts and takes you're thinking about?

**Michael Petters**

Well. There was a four structure assessment done four years ago that we could see the -- we could actually see ahead of that assessment. We could see that operating tempo of the Navy was higher than the structure that the Navy had to support it. And we anticipated that there would be some expansion. We're now at a place where there have been a lot of new ships put under contract. And I think that the opportunity now is, as we're building up this capacity in the industry, do we have the opportunity to kind of rethink through the --

we're can we create new future capability. And I know that maybe leadership has been thinking really hard about that. I think the Marine Core has been thinking really hard about that.

We're engaged in those discussions, and we stand by to assist in any way that we can in ways that make sense. I think there is a very strong recognition in the Navy that you just can't go and make a hard left turn or a hard right turn because the Navy is so dependent upon its industry for its capacity. And I think Navy leadership has a very mature understanding of that. And so we think that the -- sitting here today with a record backlog of production for the next few years, it is the time for us to think about what's the next phase of shipbuilding look like? What are those ships going to look like? What are the amphibs going to look like? What are the carriers look like? And I think that's going to be a very positive discussion for the nation. And I think the industry, at least for HII's part, we stand ready to help go make that happen.

**Joshua Sullivan**

Got it. And then just with regards to some of the automation efforts, you're standing up at the Newport yard. Can just walk us through the milestones? And how we should see that benefit rolling in going forward?

**Michael Petters**

Well, we are using them now. This is not a role in implementation. We're using these product on CVN 80 now, and we're very pleased with how they're being utilized and the results that we're saying. That being said, there were -- we assume some of those savings in 80 and 81 contracts. So we're very pleased with how it's going. We look at how they're being developed and how they're being implemented on a very recurring basis. So we look forward to implementing a lot of 80, 81, and actually, on the Columbia-class as well.

**Operator**

And our next question comes from the line of Noah Poponak with Goldman Sachs.

**Noah Poponak**

Chris, just going back to the question previously on the implied fourth quarter shipbuilding margin being flat sequentially to get to the 8% for the year. Does that almost entirely reflect just still not knowing precisely when the 79 launch milestone occurs? Or does it more reflect that there's more risk relief cume catchup on that item staggered about the next several quarters then maybe our perception is of a big one on launch?

**Christopher Kastner**

I think that's a great question, Noah, and it's the latter, right? There is -- you absolutely retire risk in Q4 when you got to launch, but every shipbuilder knows that a lot of risk happens to the rest program. So I think you're a latter perception is probably the better one.

**Noah Poponak**

Okay. That makes sense. The only class services contract change item that you called out in the release, is it in the net 44 positive cume catcher? Or is it separate from that?

**Christopher Kastner**

It is. It's in.

**Noah Poponak**

It's in it?

**Christopher Kastner**

Yes.

**Noah Poponak**

And is it more than $10 million or less than $10 million?

**Christopher Kastner**

We don't give a specific number, Noah. I'm sorry.

**Noah Poponak**

**Noah Poponak**

Okay. I thought, I would try that anyway. On the cash flow statement, the projection or your statement that 2019 free cash flow grow year-over-year versus '18, is that true excluding that grant proceeds, just since those are up so much year-over-year?

**Christopher Kastner**

No. That's all in the calculation.

**Noah Poponak**

Is it not up excluding the grant proceeds?

**Christopher Kastner**

Yes. I don't want to get into the specifics on the cash flow statement on the call, but it's all in. Grant proceeds are in last year and in this year relative to the net free cash flow in '18 and '19.

**Noah Poponak**

Okay. And then lastly, there on the case flow statement, if you could maybe update on your -- how we see the working capital opportunity we've talked in the past about a lot of successes there over the last several years and just still -- we're still trying to hone in on how much is left. So maybe where you see that ending 2019? And what you can do with it in 2020?

**Christopher Kastner**

Yes. I think the 5% to 7% working capital percent of sales is a good place to be. And if we can achieve that going forward, I think, we'll be operating very well.

**Noah Poponak**

So I should think of that is more kind of stabilizing in terms of our year-over-year rate of change going forward?

**Christopher Kastner**

Correct. Yes, that's a great way to think about it. Of course, you have phases of programs that kick in from time-to-time, but I think the 5% to 7% is a good way to think about on a sustained basis going forward.

**Operator**

And our next question comes from the line of Jon Raviv with Citi.

**Jonathan Raviv**

Mike, I just wonder if you can get some perspective on TS inorganic appetite you'd, obviously, making some of those over the past few years. You still see an opportunity to build out some of the capabilities and/or customers and/or scale in that business, and if so, what kind of areas are you interested in, what size? And how do you see that impacting your growth profile and margin profile?

**Michael Petters**

Yes. There's a lot in that question. We planted a lot of seeds over in the TS area to see what sprouts. And right now, we're very, very pleased with the way that DOE business is moving ahead. Since we've -- since we separated the DOE business from shipbuilding, we have -- we've been on the team for winning 3 and we're prime contractor now for DOE, doing a prime at Los Alamos. So we think -- and we think that there is more opportunity there to take advantage for our environmental skills and our nuclear operation skills. And so that's a pretty important area to us.

Our customer in the Navy is very interested in the unmanned space, particularly, I think the unmanned undersea space is a little bit more mature than the unbanned surface space. But in both of those cases, we see that, that's where our customer is going, that's our principal partnership for this business. And so we're trying to find the best way to support our customer on that. Make sure that we have the capabilities that we think are -- that the Navy is going to need for us to have going forward. And so we're -- we continue to work to strengthen that part of our business. We have always, for the -- at least for the last 20-some years, we've been supporting the fleet around the world. And as we've built some more capability there, we have also built some capability to support the Air Force and the Army. Whether it's in training or modeling and simulation or other kinds of operational things, we find that to be a really, really good business, and we continue to pursue those opportunities. And all of that, all -- every one of those areas has a need for capability in cyber and even intelligence. And we've built some capability within the last 12 months.

We've enhanced our capability there. So we're always in a constant review of what are the capabilities we have, what are the capabilities that our customer's needs, is there a gap? And do we find the right way to pursue that gap. Scale is an interesting discussion because I don't think we want to pursue being big for the sake of being big. On the other hand, sometimes, local scale can actually be something that creates more flexibility for a particular customer. So that's kind of how we're thinking about it. And so we are pretty active in evaluating our gaps and evaluating opportunities to close those gaps and trying to be as creative as we can. We would also say that valuations are pretty high at this point. And so sometimes, the best thing for us to do is to let it go. And so we continue to have that as an option on our table. So we're not in a place where we're trying to acquire everything that moves. We're very deliberate and very disciplined about what we do and we believe that our approach continues to build great value in the company.

**Operator**

And I'm showing no further questions at this time. And I would like to turn the conference back over to Mike Petters for any further remarks.

**Michael Petters**

Well, I'd like to wrap things up by letting you know that we are in the process of finalizing the arrangements for an Investor Day meeting to share our views and outlook for the business. This event will be held in New York City and will include a reception on the evening of February 17 and our management presentation on February 18. So stay tuned for additional details in the coming months. Thanks again for joining us on today's call. We really appreciate your time and interest, and we look forward to seeing you soon.

**Operator**

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.