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Leidos Holdings, Inc. (LDOS) CEO Roger Krone on Q3 2019 Results - Earnings Call Transcript

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Q3: 10-29-19 Earnings Summary

Press Release *10-Q* *Slides*

EPS of $1.36 beats by $0.17 | Revenue of $2.83B (10.10% Y/Y) beats by $106.29M

Earning Call Audio

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Leidos Holdings, Inc. (NYSE:LDOS) Q3 2019 Earnings Conference Call October 29, 2019 8:00 AM ET

Company Participants

Kelly Hernandez - SVP, IR

Roger Krone - Chairman & CEO

James Reagan - EVP & CFO

Conference Call Participants

Edward Caso - Wells Fargo Securities

Robert Spingarn - Crédit Suisse

Cai von Rumohr - Cowen and Company

Seth Seifman - JPMorgan Chase & Co.

Sheila Kahyaoglu - Jefferies

Matthew Akers - Barclays Bank

Jonathan Raviv - Citigroup

Tobey Sommer - SunTrust Robinson Humphrey

Gavin Parsons - Goldman Sachs Group

Jonathan Ladewig - Stifel, Nicolaus & Company

Operator

Greetings, and welcome to the Leidos Third Quarter 2019 Earnings Conference Call. [Operator Instructions]. Please note, this conference is being recorded.

At this time, I will turn the conference over to Kelly Hernandez with Investor Relations. Ms. Hernandez, you may now begin.

Kelly Hernandez

Thank you, Rob, and good morning, everyone. I'd like to welcome you to our Third Quarter and 2019 Earnings Conference Call. Joining me today are Roger Krone, our Chairman and CEO; Jim Reagan, our Chief Financial Officer; and other members of the Leidos management team. Today, we will discuss our results for the quarter ending September 27, 2019. Roger will lead off the call with notable highlights from the quarter as well as comments on the market environment and our company's strategy. Jim will follow with a discussion of our financial performance and our guidance expectations. After these remarks from Roger and Jim, we'll open the call for your questions.

Today's discussion contains forward-looking statements based on the environment as we currently see it and as such does include risks and uncertainties. Please refer to our press release for more information on the specific risk factors that could cause actual results to differ materially. Finally, during the call, we will discuss GAAP and non-GAAP financial measures. A reconciliation between the two is included in the press release that we issued this morning and is also available in the presentation slides. The press release and presentation as well as the supplementary financial information file are provided on the Investor Relations section of our website at ir.leidos.com.

With that, I'll turn the call over to Roger Krone.

Roger Krone

Thank you, Kelly, and thank you all for joining us this morning for our Third Quarter 2019 Earnings Conference Call. We're pleased with the continued momentum in our business reflected in our third quarter results, which set new records for revenue, backlog and bookings. Our results underscore our success in growing all segments of our business and demonstrate our ability to deliver our broad capabilities across our diverse customer base.

Starting first with the growth engine of the company: Our business development efforts. Results in the quarter were strong even beyond typical seasonal levels. We booked a record amount over $5 billion of net new awards in the quarter, resulting in a book-to-bill of 1.8x. These results reflect several notable awards, including a $400 million contract in our defense business for the provision of aircraft intelligence surveillance and reconnaissance support services in support of the Army's Program Executive Office intelligence, electronics warfare and sensors.

We were also awarded a $900 million contract in our Civil business by the Transportation Security Administration to continue to provide Integrated Logistics Support services to sustain TSA passenger-screening equipment at hundreds of airports and other designated facilities across the U.S. and its territories. During the quarter, we run -- we won roughly $1.3 billion of awards from our classified customers, reflecting growth across each of our customers in the Intelligence Community. Our success reflects mission-enabled solutions across transformational software development, analytics and digital transformation.

Our success in executing against our pipeline allowed us to increase our backlog to a record level of $23.9 billion, a leading indicator of our future growth potential. Beyond that, we also have a nearly $35 billion of submitted proposals awaiting decision. This still includes several large programs: GSM-O II, Hanford and Navy NextGen, all of which we expect will be awarded in the next couple of quarters.

Revenue growth continued to accelerate in the third quarter with year-over-year organic growth of 12%. This growth was broad based across all of our businesses and reflects the success of the scale and diversity of our portfolio. Underpinning our growth was another strong quarter for hiring as we added another 2,500 people, bringing our year-to-date total to over 7,500 new hires.

While the market for talent continues to be tight, our success in hiring in our key growth areas reflect the investments we have made in our organization, our employees and our culture in making Leidos a great place to work. We are proud that every day, nearly 34,000 people choose to work at Leidos, and we take very seriously our responsibility to make their work life more rewarding in order to maximize our ability to retain them and to attract more top-performing talent. Strong margins and a continued resolute focus on cash conversion allowed us to generate nearly $350 million of cash from operations in the quarter, resulting in a quarter-end cash and equivalents balance of $635 million.

During the quarter, we deployed our excess capital consistent with our stated capital deployment philosophy, which balances investments for growth, including organic and M&A, with returning capital to shareholders through dividends and share repurchases. We executed a $200 million accelerated share repurchase during the quarter, which resulted in the retirement of 2.4 million shares outstanding. Beyond this, our M&A pipeline continues to be very robust, and we have been evaluating opportunities across all of our big -- business segments for acquisition targets, both big and small. While we routinely assess the market landscape for potential targets, we run a disciplined process for evaluating opportunities to ensure transactions -- that transactions enable us to improve our strategic position and drive shareholder value. Many of the opportunities we have evaluated did not meet our criteria in these areas. However, we were pleased that 1 target did.

We announced and closed the acquisition of IMX Medical Management Services during the quarter, and we are pleased to welcome IMX into the Leidos team. Our combined experience, footprint and commitment to customer service positions us to be a significant player of independent medical evaluations in the commercial market as we are today in the federal space.

In the quarter, we also divested our health staff augmentation services business in a sale to Alvarez & Marsal Capital. The business that was divested was a small, immaterial piece of our overall portfolio, which delivered staff augmentation services to commercial health care providers. This divestiture helps Leidos focus on what it does best: Providing solutions that meet the complex needs of our government or other highly regulated and complex industries. We recently completed a major milestone in one of our marquee programs in this area, the DoD Healthcare Management Systems Modernization program, or DHMSM, the largest IT transformation in the history of the military health system. The Leidos partnership for defense health successfully deployed MHS GENESIS to a new wave of military treatment facilities on September 7, 2019. Following the release, our customer, Program Executive Officer of the Defense Healthcare Management Systems, lauded us for what he called a very successful release at Wave Travis.

As I said before, patients' safety is our #1 priority. We added 6 new technical capabilities to MHS GENESIS in advance of this wave, including CV Pax, a system that can be used to treat various heart conditions. Within the first 48 hours of go-live at Travis Air Force Base, a heart attack patient was successfully treated using CB Pax, a capability that did not exist at this hospital before MHS GENESIS.

We also introduced enhanced training curriculum during this wave and noticed a significant increase in the speed of adoption at each site. We continue to make substantial progress on this program, and with this wave behind us, we are looking ahead to the next 2 waves, which have just kicked off predeployment activities right on schedule. These are Wave Nellis, which includes Nellis Air Force Base in Las Vegas, Nevada; and Wave Pendleton, which includes Camp Pendleton in San Diego, California. Wave Nellis is on track to go live in June 2020. Finally, turning now to the macro environment. Conditions continue to remain favorable. The 2-year budget agreement, which provides top line spending amounts for both defense and non-defense spending accounts, creates a supportive foundation for the continued growth of our business. While we are starting the government fiscal year with the continuing resolution as we have for 19 of the last 20 years, we see no material impact from a CR that lasts potentially through the end of the first quarter and could even last through the full government fiscal year 2020. While we are optimistic that we will avert a government shutdown, we are also prepared for this scenario should it occur.

As we look ahead, the strength of our results thus far in the year and the continued acceleration in revenue growth gives us confidence to raise our expectations for the year across all guidance metrics.

I'll now hand the call over to Jim Reagan, our Chief Financial Officer, for more details on third quarter results and our revised guidance.

James Reagan

Thanks, Roger, and thanks to everyone for joining us on the call today. In the interest of getting to your questions, I'm going to focus my comments on providing some context to the results disclosed in our press release and summarized by Roger.

Revenue grew 10% and 12% organically when you normalize the effects of the commercial cyber and health staff augmentation divestitures. Organic growth was broad based and driven by high levels of on-contract growth and increased contribution from new programs which ramped during the quarter. Adjusted EBITDA margins were 10.7%, reflecting strong margins in the core business as well as the following. First, the payment of an arbitration award relating to work performed for the Greek Olympics back in 2004. A big thanks to the significant effort by our legal team that resulted in the long-overdue receipt on this work. We collected $59 million in cash from the Greek government and recognized a net $54 million reduction of operating expenses on this item. And this was partially offset by a $19 million provision for certain other international receivables, and this was reflected in the Civil segment results. The net effect of these 2 items was a $35 million benefit.

The second, revenues in the third quarter reflect a higher mix of material volumes, which put downward pressure on margins. And lastly, we incurred significant startup expenses on certain large new program wins, most notably in our Civil business, where we expect margins to revert back to normal levels in the fourth quarter. These items, along with a lower share count, helps to drive non-GAAP diluted EPS of $1.36, an increase of $0.22 over the prior year.

Operating cash flows of $349 million in the quarter reflects the seasonally strong government fiscal year-end as well as higher advance payments which reduced our accounts receivable and contributed to the reduction in days sales outstanding to 57 days. We expect much of these advances to reverse in the fourth quarter, getting us back to a more typical DSO level in the high 50s to low 60s.

Bookings of $5.2 billion were strong across all segments and resulted in a 1.8 consolidated book-to-bill with ending backlog of $23.9 billion. This is once again an all-time high for the company and reflects an 18% increase over the prior year.

Now for an overview of our segment results. Defense Solutions grew 8.3% over the prior year quarter, driven by elevated levels of on-contract growth on our mature programs plus new program revenues. Non-GAAP operating margins of 8% declined 60 basis points sequentially and 50 basis points from the prior year primarily on higher materials revenues and lower write-offs. And despite elevated protest activity during the quarter, our Defense Solutions business booked over $2.7 billion of net awards, resulting in a book-to-bill of 2.0x for the quarter and 1.3x on a trailing 12-month basis. In our Civil segment, revenues grew 10.4% sequentially and year-over-year. Organic revenues grew 13.4% when adjusting for the sale of the commercial cyber business which closed in the first quarter. The primary driver of Civil revenue growth both sequentially and compared to the prior year was an increase in new program revenues. Non-GAAP operating margins in our Civil segment of 7.8% were uncharacteristically low, declining 210 basis points sequentially and 540 basis points from the prior year quarter.

Margins reflect two unusual items in the period, which combined, resulted in 220 basis points of negative margin impact. Adjusting for this, the margins in the business were over 10.2%, up slightly from the prior quarter. And these 2 items were: First, the bad debt expense I referred to earlier is reflected within the Civil results and drove a $16 million charge in the quarter; and second, startup expenses associated with a new program ramp -- for a new program that involved a large materials buy component. Because the payment for these costs is made over time, the related profits are recognized over the next 5 years of the program, and this contributed to a margin headwind in the quarter. Civil segment bookings of $1.1 billion were once again strong and drove a book-to-bill of 1.2 for the quarter and 1.0 on a trailing 12-month basis.

In our Health segment, revenue growth, bookings and margins were all the best performers in the company during the quarter. Revenues there grew 14.4% over the prior year period. Growth was driven by a variety of factors: Strong levels of on-contract growth, increased revenue contribution for the ramp in the DHMSM wave deployments and revenues from other new programs. Non-GAAP operating margins of 14.8% were 40 basis points higher sequentially and 60 basis points higher than the previous year, driven by strong execution across a variety of mature programs in the portfolio. Health bookings were very strong in the quarter at $1.4 billion, largely driven by a mix of on-contract growth and recompete decisions. This resulted in a book-to-bill of 2.7x for the quarter and 2.1x on a trailing 12-month basis.

With the strength of our Q3 results and the continued large pipeline of submits outstanding, we remain confident that we will continue along the growth path we've been on now for over a year. And as such, we are revising our 2019 guidance upwards as follows. We expect revenue for the year between $10.9 billion and $11 billion, a $150 million increase from the midpoint of the previous guidance and about a 7.4% increase at the midpoint over the prior year. Further, our results thus far in the year and our visibility into fiscal 2020 has further increased our confidence in our continued growth momentum into 2020. As always, we will provide more information on our fiscal 2020 guidance in our fourth quarter earnings conference call.

We expect adjusted EBITDA margins for the year between 10.2% and 10.4%, a 30 basis point increase at the midpoint from the previous guidance. We now expect non-GAAP diluted earnings per share between $4.90 to $5.10, an increase of $0.38 from the midpoint of the prior guide. This reflects the higher expected net income and lower share count resulting from the ASR completed in Q3.

Finally, we expect cash flow from operations to be at least $875 million, up from the prior floor of $825 million, reflecting the Greek arbitration award. One additional note related to free cash flow. We now expect capital expenditures for the year of approximately $125 million, which is $50 million lower than our prior guidance of $175 million, which is primarily driven by lower expected real estate spending.

Now with that, I'll turn the call over to Rob so we can take some questions.

Question-and-Answer Session

Operator

[Operator Instructions]. Our first question comes from the line of Edward Caso with Wells Fargo.

Edward Caso

Great. Congrats here. I was curious about your cloud positioning, particularly in the wake of the JEDI decision. How does Leidos play in the whole, what we're hearing as an accelerating transition by the Defense Department to the cloud?

Roger Krone

Thanks, Ed, and good morning. We tend to utilize the cloud as purchased by our customer. So think of our business as cloud transformation or moving applications from legacy to the cloud. And in some contracts, we will contract with AWS, Azure or whomever for cloud services as a pass-through, but typically, the actual provisioning of the provider of the cloud is not in our contract. So we tend to do the value-added of converting legacy to cloud. And that's true really across the board, whether it be in a DoD or in our Civil or Health business. So we call this sort of digital transformation, and it's one of the largest areas of -- in our pipeline. And the decision by the Department of Defense to go with Microsoft Azure versus AWS is really immaterial to us. We won't be affected by that decision in any way.

Edward Caso

I have a question that's around -- you talked a little bit about the CR, but it looks like we're heading to at least a second one. At what point does the extension of CR start to impact the forward outlook?

Roger Krone

Yes. Yes. For us, really very little, if at all. We've looked at -- we first looked through end of November and then we thought maybe end of the year. And then we've done analysis through the first quarter. Now we've run it for the full fiscal year. And we don't have a lot of 2020 new starts in our pipeline, so I would say it's minimal. You never want to say it's 0, but it's really immaterial for us relative to what's in our pipeline. I think it's complicated and it's complex for our customers who are trying to put together budgets and think long term. But because of the increase that we've had with the two year budget, where we come off the prior year budget process for the purpose of the CR, we're actually in pretty good shape.

Operator

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

Robert Spingarn

So I wanted to ask a couple of things, if I might. Roger, I wanted to start with your commercial strategy as it stands today. Is this a business you're seeking to expand in light of the IMX acquisition? Or is that more specifically targeted for those assets?

Roger Krone

Sure. Thanks, Rob. We've been successful in doing disability assessments for the VA. And as such, we have built what we think is a national capability to do medical exams and disability assessments. We believe there's a parallel for corporations, health care centers, private employers. And that industry is starting to consolidate and we just see it as an opportunity to take, if you will, sort of our back end and the process work we've done for the government and to apply that in the commercial marketplace. And the easiest way for us to get a foothold was through an acquisition, and we were pleased to be able to come to terms with the team at IMX.

Robert Spingarn

Okay. And then at a higher level, I wanted to address the relationship between sales growth and record backlogs but also this idea that the duration of backlogs appears to be expanding across the industry. So meaning that if duration is extended, you might expect growth to slow a little bit. So I wanted to ask you how will you think about those two factors. Or is this double-digit-type growth just supportable for a while?

Roger Krone

Let's see. A couple of quick comments. As we look at the duration in our backlog, it's approximately the same. So for us, I can't speak for the rest of the industry, we don't really see it stretching or contracting. And so therefore if you follow the logic as sort of you laid out, if we have high -- a large number of wins, we increase our backlog, we see organic growth, then that's sustainable through the duration of what's in our backlog. And we talked about this in prior calls. It just takes so long, right, in our business for backlog programs to start, for that to flow through the PPBS system and actually turn into revenue for us. This is like a 2- or 3-year forward-looking momentum. And although we can't predict the outcome of the election or what will happen to budgets post that, we feel very, very confident now for multiple years looking forward.

Operator

The next question comes from the line of Cai von Rumohr with Cowen and Company.

Cai von Rumohr

So a number of your competitors have kind of noted that bookings have been slowed by lots of protests, decisions happening late. And certainly in your case, GSM-O, Hanford and NextGen have moved to the right. Two questions. One, what do you think is causing this phenomenon and maybe with some specifics on your 3 outstanding bids? And maybe update us on kind of the status of protests either of things you've won or things you've lost.

Roger Krone

Let's see. Thanks, Cai. I would tell you that it's almost like a seasonal delay. It's just momentum, people, staffing, programs getting through peer reviews in the building and then getting to award. And I actually don't think these delays are atypical. I mean sometimes a program -- we've actually had some that came out early. But typically, we always add 90 days or so to award dates that are promulgated by customers because it just -- they take so much time to get it right. And because of the expected protests, they want to sort of white-glove the decision so that they can sustain a protest.

In the protest front, without going through everything that's in protest, maybe a quarter or two ago, we were down to almost nothing, either offense or defense. And now with a summer of awards, some that were awarded to us, some that we lost, we've seen the protest volume increase. And I think that's very typical with sort of the awards seasonality that we have in the government cycle, that a lot of things are awarded just at the end of the government fiscal year, and then therefore a lot of protests happen at that time, and that's what we've seen.

On our major programs, we expect Hanford and GSM-O in the fourth quarter, probably maybe NextGen first quarter or shortly thereafter. But I'm sure you would remind me, at one time, I thought Hanford would be awarded in July. And so we all -- we stay close to the customer, we keep our bids fresh, and we hope that they get through their award process and these things get awarded before the end of the year.

Cai von Rumohr

And just the last one. Jim, you mentioned the adjustments in Civil. In defense, your margins looked a little lower. You mentioned the materials being up. And maybe give us some -- how much -- yes, and the EACs being down. Can you give us a little more granularity on some of those issues?

James Reagan

Yes. We have won an Army contract, Cai, where we had a -- they have some -- I wouldn't even call it seasonal, some not entirely predictable lumpiness in some support-related materials purchases that we make that carried lower margins. And that within the quarter was a margin headwind. And then I think as I mentioned, there were a higher level of EAC write-ups in the period a year ago. So those are the 2 primary contributors to the defense margin change year-over-year.

Operator

The next question comes from the line of Seth Seifman with JPMorgan.

Seth Seifman

I wonder, is there any more additional detail you can give about the charge in Civil? Sort of what contract that is and what gives you confidence that any issues are behind you, the $16 million bad debt.

James Reagan

Yes. Seth, I don't want to get into the details around the specific contract. I can tell you though that the decision to take a provision on these receivables, which relate to overseas contracts that we had in the Civil group, were based primarily on conditions we saw on the ground and where the status was on our efforts to get some outstanding receivables collected.

Of course, as we mentioned earlier about the recovery of this arbitration award on Greece that was long outstanding, similarly, the receivables that we've taken a provision for in a different geography in the world, we're not going to stop our collection efforts there simply because we've taken a charge on it. And you can easily -- I can see a scenario where sometime in the future, several quarters or maybe even a couple of years, we'd see recovery on that. But for right now, we thought the prudent thing to do was to take a reserve for it.

Roger Krone

And Seth, that was a $19 million charge. When you boil it all down between the recovery on the Greek arbitration award and the provision we took on those other overseas receivables, it's a net of about $35 million.

Seth Seifman

Right. And then just a follow-up. Looking through the year thus far, it looks like to reach the EBITDA margin guidance, we're looking at something in the 10.3-ish range for the fourth quarter. The last two years, we've seen the margin tick down in the fourth quarter. What kind of gives you the confidence in that fourth quarter margin?

James Reagan

Yes. I understand your question, Seth. Actually, I think that the implied margins in Q4 are a little bit higher than that. But it really has to do with -- we've got good visibility on what the revenue mix is for Q4. And as I mentioned during the prepared remarks, we're expecting the Civil margins to recover back to what we normally see. We'll see that in the fourth quarter. Actually, could be even stronger there. And again, Q4 looks like a strong revenue mix of fixed price and unit price-related work that will generate some stronger-than-normal Q4 margins.

Operator

The next question is from the line of Sheila Kahyaoglu with Jefferies.

Sheila Kahyaoglu

Just expanding maybe on the last question with regards to all 3 segments. You've had a bunch of new wins and strong revenue growth. How do you think about the margin mix, where it's been impacted most and how you think about that bridging into 2020?

James Reagan

Sheila, I appreciate the question, and we think about this all the time. The -- as we've said before, ramp-up of new programs, and we're certainly seeing a little bit of this -- well, certainly some of it in Q3. In the early phases of a program ramp, the margins tend to be lower than they are for the normal life of the program. We had some new program ramps in the Civil group that we had to take some upfront provision on, and you see that in the Q3 results. We don't expect that to recur.

And as revenue growth is higher than what we might have guided to previously, one might think that, that would put some additional pressure on margins going forward. In fact, we haven't seen as much of that pressure as we had previously discussed. And that I think speaks well to strong program execution, and you see that across the program ramps that we have in Civil, where as I mentioned, that dip we had in margin in the first quarter gets recovered in future periods. And that's an artifact of the accounting for some leased equipment on a couple of programs.

Particularly in the -- if you're thinking about the Health margins, we are now -- and we continue to believe that the Health margins, which were very strong in the quarter, continue to be sustainable. And we're very pleased with execution on some of our newer and even more mature programs within the Health group.

Sheila Kahyaoglu

Great. And then maybe just a question on Health to expand on that. Roger, thanks for the color on IMX earlier. How do you think about that portfolio? The margins have been quite strong, you're adding IMX, divesting the health augmentation business. Kind of how do you think about expanding that or what that business looks like over the next few years?

Roger Krone

Well of course, Sheila, as you implied, we're investing in the part of the business that's doing well. So that should give us confidence in our margin. We were able to sell part of the business that really wasn't in our portfolio. Clearly, that would have been lower-margin for us. I think it will do better in the hands of someone who's more focused on that business.

We continue to be very confident about the performance in the Health group. But we're -- obviously, we don't guide by our segment. We're not going to do it here. But you would expect us to double down on parts of the Health business that are doing well and to exit those that don't fit our strategy and our portfolio going forward, and that's exactly what we did.

Operator

The next question is from the line of Matt Akers with Barclays.

Matthew Akers

I wanted to ask if you could elaborate I guess a little bit on the M&A market, what you're seeing there. You mentioned a little bit in kind of the opening remarks, but sort of what have been the deals that you looked at so far? Where have they fallen short? Is it just the valuation or just kind of lack of something that's a good fit with Leidos?

Roger Krone

Matt, it runs the gamut. Some, we just can't -- we're net present value kind of people as opposed to multiple people. So we're looking -- we look at M&A, we're looking -- we do like a 5-year off and a 10-year set of forecasts. So -- and then we discount that back. So that drives value. I think other people are buying off of multiple, and that's not where we are. We're really looking for the long-term value in a company. So there's some deals that have been priced away from us.

I'm sure you're familiar with the process. You often get an offering memorandum or a management presentation. And of course, when that happens, everything looks great. And then you get in and do due diligence, and what was thought to be a high value-added company looks more like a training company or something. And so we want to look at a lot because I think there is continued defense and civil consolidation and we want to be part of that. But we want to make sure that it tracks well with our strategies. And so we will -- again, we'll be involved in the front end of a lot of transactions. We don't expect to be there at the end on very many.

Matthew Akers

Got it. And then I guess, I think you mentioned 2,500 headcount adds in the quarter. Was that the gross number? And if so, could you give us what the attrition was?

Roger Krone

Yes. That's the gross number and we don't really recount the net number. But obviously, the net number is going to be less than that. And I think we actually put the headcount in our release so you can track our headcount quarter-to-quarter. But we are -- continue to be confident in our ability to attract people, also people with the appropriate security clearances and the right experience and educational background. And we have a great team that does talent acquisition for us. But I think there's also something about some changes that we've made and the image that Leidos has out there in the workforce and how we treat our employees and how we've made this a great place to come to work.

Operator

Our next question is from the line of Jon Raviv with Citigroup.

Jonathan Raviv

Just back to the margin question for a moment, guys. Implied 4Q in the mid-10s, I think you called the Health result somewhat sustainable as you double down on the higher-margin stuff. And now two years in a row, nicely booked 10% adjusted EBITDA. So is 10% still the normative -- the right normative rate to think about going forward here?

James Reagan

Yes. Jon, this is Jim. What we said in the past is that we're looking for longer-term adjusted EBITDA margins 10% or north of 10%. And you're right in how you're thinking about Q4. It is continued sustainment of strong margins in Health but also what we think is -- what we know is going to be nice recovery is the margin profile of the Civil group which, for some time, has been set up for a nice Q4 margin with -- based on orders that are currently in the pipeline for certain things. And so that speaks to the confidence that we have both in Q4 and the full year margins.

Jonathan Raviv

Okay. And then bigger-picture question on the M&A strategy. I mean, Roger, you mentioned you're interested in things both small and big. What does big mean to you? And with the company in a place where growth is strong, the BD machine is running nicely, what is missing? How do you weigh kind of getting -- adding an all-new big thing to a machine that seem to be running quite nicely?

Roger Krone

Yes. Okay. So small tends to be the $50 million to $100 million in revenue. By the way, big tends to be over $1 billion in revenue. So -- and I will share we're not looking at an ISGS-size big. I mean I've just -- we just don't see anything on the landscape that would be like the deal that we did in '16. And our strategy on M&A really is to look at 2 things, is capability and customer. So is there an aspect of our business that we think we need that we don't have to complete a portfolio for a customer? Or is there some customer access, past performance calls, scale that we don't have to be able to appropriately address a segment of the marketplace that we're not in today? And I know it may seem like we're everywhere, we're actually not. There's a significant amount of our customer base that we would call not addressable at this time. And so we look at those areas. And again, we've got a criteria that we use we talked about at our Investment Day back in May, and those are the criteria that we use to filter our M&As.

James Reagan

And Jon, when we think about investments in M&A, in many ways, you can think about our investments in internal and organic growth the same way. And we've been be making some significant investments over the last couple of years that you're seeing reflected in our top line organic growth for Q3 and for the full year. And as long as we're getting nice dividends on those investments, you're going to continue to see us focus on that as much as we are looking for the right accretive -- both strategic and financially, the right, accretive kinds of acquisitions.

Operator

The next question comes from the line of Tobey Sommer with SunTrust.

Tobey Sommer

I was wondering if we could start -- Roger, can you talk about constraints to growth? What are the sort of limits to the company's ability to grow organically?

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Roger Krone

Well, okay. So we haven't found those yet. And you can kind of break it into a couple of categories. Access to capital markets probably has never been as good for us as it is today, the cost of borrowing is low. Because we're a people business, all of our strategies revolve around our people and our talent, and I would put that in 2 categories: Our business development team and our ability to develop those relationships with customers and to pursue procurements, which is a multi-year campaign for us. And so you have to have the customer relations people, the business development people, the proposal people. And those are probably the most rare commodity in our market today.

And then on the backside, you don't want to bid on a program if you cannot staff post award. And so we're really, really thoughtful about what we bid on and our ability to attract people. As we all know, very, very difficult to hire in the national capital region. And so as we look at things going forward, we're excited about opportunities where we can staff the program in places other than the Virginia, Washington, Maryland, Delaware. So if there was a program in Colorado Springs or Denver or St. Louis, then that would be a great place for us to look simply because of all the economic growth that has already occurred here in the D.C. area.

Operator

Our next question comes from the line of Gavin Parsons with Goldman Sachs.

Gavin Parsons

On the revenue guidance, it's the second raise this year. So just curious if you could talk a little bit more about what's surprising you kind of relative to your initial plan? If it's better new business wins, higher recompete win rate, more on-contract growth, faster movement by the customer, just any color there would be great.

James Reagan

Well again, I think you just hit on all of them. Just to put a little bit more color around it. Roger had just alluded to being able to attract the talent that we need to be able to convert backlog into revenue. We're pleased with how we're doing in terms of the process and backlog into revenue. We're pleased with how we're doing in terms of the process and capabilities we have in our HR and recruiting department. They're doing a fantastic job of helping us meet the customer needs.

The second one is there's been -- when we look at the additions to backlog and the components of book-to-bill this quarter, about 1/3 of the additions to backlog are new work and takeaway. And then about 1/3 of it is growing existing programs, either through addition of option years or on-contract growth, much of which is actually sold by the people that are working every day with the customers. And we've had a lot of focus across the business in on-contract growth. And then another 1/3 of that comes from successful acquisition of recompete business. So it feels -- and if it sounds like it's a kind of a balanced way to look at it, it certainly is.

And so I think that the way that we're getting to a better than previously expected revenue is just strong execution, both on the program side and great people and process and the return on the investments we've made in our business development teams.

Gavin Parsons

Got it. And then you mentioned no extension in the kind of backlog duration. The total book-to-bill has been great, but funded looks maybe a little bit soft on a trailing 12-month basis. Does that have any implications for kind of next 12-month growth relative to kind of the longer period that's supported by total backlog? Or is that just lumpiness here?

James Reagan

Yes. That really is -- it speaks to some lumpiness in how the backlog gets funded. We're not worried about the downtick in the funded piece of the backlog, Gavin. I think that the other point relative to the duration of backlog, which is not materially changed, it is the -- it speaks to the comment that I made during the prepared remarks that it gives us more confidence coming out of 2020 in the growth rate that we've been putting out there for post '19. And we'll have more comment on what our expected growth is looking like beyond 2019 when we put our guidance out there, and we'll do that in the Q4 call.

Gavin Parsons

Okay. And if I could sneak a quick last one in. Just as you mentioned, the -- doing a great job hiring. Are you able to get people on contract more quickly or get them cleared faster? Or is there any sort of kind of operating leverage that still needs to flow through the margin as you get those people on contract?

Roger Krone

Yes. Gavin, it's a little bit better. I'm -- I don't think anyone in the industry is just out celebrating yet. I mean there's hope, maybe 6 months or a year, that process will continue to be streamlined. One of sort of our business models is you may have a mental image that we have 2,500 college hires. And our approach really, we have maybe only 10% of that number is college hires. We tend to try to recruit more midcareer people, and that means they often already have a clearance. Or maybe they have what we call a secret, and then it's a little easier for us to get them the hire, security clearance, if they come in to us with a secret.

So our time typically from hire to getting them cleared and getting them onto a contract and generating revenue tends to be shorter than the mental picture you may have of you get somebody out of a college and university and they start their paperwork, and it's often an 8-month, 12-month journey. So it's part of our strategy on attracting a workforce where they've already been through the adjudication process.

But the clearance process in and of itself has gotten better, but it is -- and the backlog is significantly reduced, both by the way, on the contractor side and on the government side. But the work flow through the process is still way too long and probably a minimum of 6 months. And some people, depending upon if you've lived overseas, could be as long as 18 months.

Operator

The next question is a follow-up from the line of Seth Seifman with JPMorgan.

Seth Seifman

Roger, I was just wondering, we hear a fair amount from DoD these days about Fourth Estate reform. And I was wondering if that's something that you're kind of focused on at all and whether you think there's any potential impact on Leidos and on the services space.

Roger Krone

Yes. Obviously a lot going on in that area. We know that the new Secretary of Defense and the Head of Acquisition are doing reviews on the Fourth Estate. Maybe for everybody else on the call, the Fourth Estate tends to refer to noncombat agencies in the Department of Defense, organizations like DISA, DLA, maybe some of the 3-digit intel organizations, that are viewed not as a direct combat organization. And there -- when Secretary Shanahan was there, and Secretary Esper, view this as an opportunity to apply technology to create more efficiencies, and therefore to maybe harvest some budget there to be able to spend directly on combat organizations.

We have a great balance between the services and these support organizations. We work closely with them. Our business tends to be around driving efficiencies into these organizations. I mean it's really what we do. In some of the contracts we've had, we've taken out numbers like 20% of top line costs. So we actually view the activity that's going on right now as an opportunity for us, both in the contracts that we already have with these agencies and opportunity for new contracts in organizations like DLA.

As you all know, we were fortunate enough to win a program in the United Kingdom called LCST where we have done essentially digital transformation of commodity purchase and distribution in the United Kingdom. And our -- we get rewarded there based upon driving efficiency into their procurement system. We have learned a lot about how to run a procurement organization and how to modernize processes. We think those lessons learned are directly applicable to some of what the Secretary would like to do in the Defense Logistics Agency here in the U.S., and we look forward to the opportunity to respond to RFIs and RFPs and help our customer think about how they can transform, if you will, some of these Fourth Estate organizations.

Operator

The next question is from the line of Joe DeNardi with Stifel

The next question is from the line of Joe DeNardi with Stifel.

Jonathan Ladewig

This is Jon on for Joe. Can you kind of update us on what's driving the success in your new wins and takeaways and how this kind of plays into your recompete win?

Roger Krone

Well, boy, gosh, if I knew exactly what was working, I probably wouldn't -- I might have even a higher rate. Let's see. You all have been on this call for quarters. And you know a couple of years ago, we felt we were not winning as much as we had hoped or we expected. And we really went back through and thought through our whole relationship with customers; how do we qualify our pipeline; our bid, no-bids or pursues; and the whole business development process around how do we create an offering and how do we do pricing and then how do we write proposals? And it really was a sort of a top-to-bottom overhaul of the processes that we inherited both from Leidos and from IS&GS and really, what we think, was took the best of all the processes out there and rebuilt our business development processes and in to some way our organization.

And what you're seeing now is what I call the time constant of when do you address the issue, and then how long does it take to flow through sort of the PPBS proposal process? If I implement a new proposal process, you don't see it in a win until 18 months later because that's how long it takes to go pursue an opportunity, work with a customer on their program work statement, on the procurement, actually get an RFP, write a proposal and go through the evaluation cycle. And the good story that we have today is really based upon a lot of hard work that was done 18 months or 24 months ago. And that was of course in response to a couple of losses we had 2 or 3 years ago. So Jon, I hope that answers your question.

Operator

We have a follow-up question coming from the line of Robert Spingarn with Crédit Suisse.

Robert Spingarn

Just wanted to ask you one more thing. Kind of specific, but I thought it was interesting what you're doing with the Army and the ISR world. And this business that you have, which I guess is a company-owned, company-operated or COCO structure, sort of a big safari where you own the assets. I wanted to ask you if -- how you're thinking about this kind of opportunity, the risk there? And what other opportunities? Is this a business you want to grow, this sort of COCO approach?

Roger Krone

Let's see, Rob. As you know, we have been in the mission support business forever. And then going back to -- back when we had a significant amount of OCO work, we all work all -- 5, 6 years ago, you all used to ask how much OCO work we had. And that was specifically related to aircraft in theater that were doing collection missions. What we have said is we want to be in a mission support role with a host of customers and that we were comfortable with multiple business models, from GOCO, OCO in our ARL-E program, we simply will be providing an airplane to the Army for the Army reconnaissance low enhanced program, we -- actually modern airplane, and we DD 250 that airplane and provide it to the customer.

We have seen some opportunities as of late to invest in aircraft, in capital, and then to provide those as more of a COCO model. And those have allowed us to be a little bit more responsive, to get capability to the field faster because it's entirely within our control. But it is not going to be overweighted. It is part of our portfolio and our mission support business. And we're, again, pleased with the opportunity we've had to provide that capability.

At the same time, if you were to go to our hangars and look at our stable of programs, you would find other aircraft in the other models. And then of course, we have our Afghan support program where, through an Army contract, we actually support the Afghan Air Force the Mi-17s in theater. And that's on a direct support program. So again, we have broad portfolio of contracts in our Army and multiservice ISR business.

Robert Spingarn

Would you say you've turned down opportunities for COCO work where the risk profile was just too high?

James Reagan

Well Rob, I think that we've been able to shape the service profile collectively with our customer so that it's acceptable with the right kind of return. And what we're able to do for our customer is to -- at a predictable cost, they pay us for availability, and that delivers what the customer wants and it gives us the right kind of return on our COCO investment.

Roger Krone

Yes. But Rob, that means that we do have some preliminary conversations with customers. And there clearly are edge opportunities that we are not -- we don't do and we're not going to do. And you know us. We're always thinking of being very capital-light. We are not an ILFC, we're not an aircraft lessor. We don't want to be in that business. We tend to invest or go over the COCO model where it's a customer we have a long history, where it's a mission that's understandable, that we think we can execute and we can make a return on our capital investment.

So I don't want you to walk away from this conversation thinking that our CapEx is going to go up and we're going to be a heavy investor in aircraft or surface ships or whatever. That's really not where we're going. This is a nice add to a business that we already had and it allowed us to access a customer that we might not have otherwise been able to access. But our typical model is sort of a standard government contract where the asset is really owned by the customer.

Operator

Thank you. We've reached the end of our question-and-answer session for today, and I'll turn the call back to Kelly Hernandez for closing remarks.

Kelly Hernandez

Great. Thank you, Rob, and thank you all for your time this morning and for your interest in Leidos. We look forward to updating you again next quarter. Have a great day.

Operator

This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.