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Northrop Grumman Corporation (NOC) CEO Kathy Warden on Q3 2019 Results - Earnings Call Transcript

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Q3: 10-24-19 Earnings Summary

Press Release *Slides*

EPS of $5.49 beats by $0.73 | Revenue of $8.47B (4.82% Y/Y) misses by $-88.38M

Earning Call Audio

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Northrop Grumman Corporation (NYSE:NOC) Q3 2019 Earnings Conference Call October 24, 2019 12:00 PM ET

Company Participants

Todd Ernst - Vice President, Investor Relations

Kathy Warden - President and Chief Executive Officer

Ken Bedingfield - Chief Financial Officer

Conference Call Participants

Peter Arment - Baird

Seth Seifman - JPMorgan

Sheila Kahyaoglu - Jefferies

David Strauss - Barclays

Rajeev Lalwani - Morgan Stanley

Doug Harnett - Bernstein

Myles Walton - UBS

Carter Copeland - Melius Research

Robert Spingarn - Credit Suisse

Noah Poponak - Goldman Sachs

Jon Raviv - Citi

Cai von Rumohr - Cowen & Company

George Shapiro - Shapiro Research

Operator

Good day, ladies and gentlemen, and welcome to the Northrop Grumman's Third Quarter 2019 Conference Call. Today's call is being recorded. My name is Erica, and I will be your operator today. [Operator Instructions]. I would now like to turn the call over to your host, Mr. Todd Ernst, Vice President, Investor Relations. Mr. Ernst, please proceed.

Todd Ernst

Thank you, Erica. Welcome to Northrop Grumman's third quarter 2019 conference call. Before we start, matters discussed on today's call including 2019 guidance and any outlook or expectations for 2020 reflect the Company's judgment based on information available at the time of this call. They constitute forward-looking statements pursuant to Safe Harbor provisions of Federal Securities Laws. Forward-looking statements involve risks and uncertainties, which are noted in today's earnings release and our SEC filings. These risks and uncertainties may also cause actual Company results to differ materially. Matters discussed on today's call include non-GAAP financial measures that are reconciled in our earnings release. Additional information can be found in the supplemental presentation posted on our Investor Relations website. On the call today are Kathy Warden, our Chairman, CEO and President, and Ken Bedingfield, our CFO.

At this time, I'd like to turn the call over to Kathy. Kathy?

Kathy Warden

Thank you, Todd. We're pleased to have you aboard as our Vice President of Investor Relations and I also want to thank Steve Movius for his many years of service in that role. Good afternoon, everyone and welcome to our third quarter 2019 earnings call. I want to thank the entire Northrop Grumman team for another solid quarter. We delivered strong business capture and backlog growth, higher sales at all four sectors, strong earnings and healthy cash flow. Year-to-date results supported a substantial increase in our EPS guidance, as well as an increase to the lower end of our free cash flow guidance, and we are on track to achieve the other major elements of guidance.

Before discussing the quarter in more detail, I want to touch on the realignment we announced in September. Beginning in January, we will have four operating sectors that more closely align with our customers' priority investment areas. Our new sectors are Aeronautics Systems, Defense Systems, Mission Systems and Space Systems. These changes will enable our teams to quickly identify and deliver solutions for rapidly evolving national security challenges. The realignment is also aimed at driving continued strong execution, sustained profitable growth and operational efficiency.

Under the new structure, Aerospace Systems becomes Aeronautics Systems and continues under the leadership of Janis Pamiljans. In addition to long-duration franchise manned and unmanned program, the sector will also include the aerostructures work currently being performed at Innovation Systems. A new sector, Defense Systems brings together Technology Services, the defense businesses of Innovation Systems and select capabilities for Mission Systems.

In addition to being our global sustainment and modernization business, Defense Systems includes tactical missiles, munitions and our Integrated Air and Missile Defense program. Defense Systems will focus on products and services that address evolving threats and quick-turn requirements for a wide variety of national security, military, civil and international customers. Chris Jones, the President of Technology Services has announced his intention to retire. I want to thank Chris for his many contributions to Northrop Grumman particularly for leading the effort to position Technology Services for the future. We wish him the best.

Mary Petryszyn, who currently heads Land and Avionics C4ISR within Mission Systems will lead the new sector. Mission Systems remains largely intact, but with a sharpened focus on growing its leadership position in open, cyber-secure, software-defined systems for defense and intelligence application. Mark Caylor will continue to lead Mission Systems.

The fourth and final sector, Space Systems brings together our significant space and launch capabilities from across the company into one organization. Space Systems will be a robust platform to accelerate the development of innovative and affordable offerings for our national security, military, civil, commercial and international customer. We expect Space Systems will be the fastest growing sector in our new structure. Blake Larson, currently the President of Innovation Systems will lead Space Systems. This realignment is the next logical step to maximize the powerful revenue synergy opportunity we envision from our combination with Orbital ATK. It also further enabled strong execution and our organization's agility.

Turning to financial highlights for the quarter. Sales rose 5% to approximately $8.5 billion and included sales growth at all four sectors. Our year-to-date segment operating margin rate of 11.5% is tracking to our guidance of approximately 11.5% for the year reflecting solid operational results. Cash from operations increased $327 million to $1.1 billion in the third quarter and free cash flow increased to $882 million. Year-to-date, operations have generated $1.8 billion of cash. After capital expenditures of approximately $800 million, year-to-date free cash flow increased to approximately $1 billion. New awards remained robust and demonstrate our strong competitive position in critical national security domain. In the third quarter, we booked more than $10 billion in new award or 1.2 times sale. Book-to-bill was above 1 times at Innovation Systems, Mission Systems, and Technology Services.

At Aerospace Systems, year-to-date, book-to-bill is 1.6 times sale and backlog is up 28%. During the third quarter, Japan exercised an option for nine additional E-2D Advanced Hawkeyes for approximately $1.4 billion. This is in addition to the $3.3 billion multi-year award we booked last quarter. I would also note that France has indicated they're interested in purchasing three E-2Ds. At Innovation Systems, we booked the initial $300 million of $1.1 billion Missile Defense Agency competitive award to supply new targets and countermeasures used to test the Ballistic Missile Defense System. Our offering provides a new solution to the complex threat scenarios our customers face.

I also note that IS has been awarded approximately $1.3 billion for hypersonic and counter-hypersonic activities, as both the prime and subcontractor. At Mission Systems, we were awarded a 13-year IDIQ to -- contract to produce and sustain next-generation navigation systems for the US Air Force and international customers. The Sole Source Award has a potential value of $1.4 billion. Mission Systems also booked a six-year $375 million order to provide surveillance radars for the Navy's Triton Aircraft, and a $200 million IDIQ Award for our layer front [Phonetic] systems and related support. And at Technology Services, in addition to winning two large recompete, TS won a competitive restricted award valued in the hundreds of millions of dollars. We're particularly pleased with this award as it demonstrates the sector's ability to win new restricted work and expand our national security services portfolio.

A good indicator of our company's portfolio alignment to the national defense strategy is our growing share of restricted work. Year-to-date, restricted awards totaled $8.5 billion. At the Company level, restricted work across multiple domains continues to grow as a percent of total revenue. As of September 30th, total restricted backlog has grown 22% since year-end, and new awards of approximately $36 billion or 1.4 times year-to-date sales. Looking ahead, we have large opportunities across our portfolio in four sectors -- in all four sectors and program execution remains solid.

Turning to Aerospace Systems. F-35 production continues to ramp up. Year-to-date, AS has delivered 100 center fuselage units and we are on pace to deliver a total of 134 units in 2019, 13 more than last year. As we celebrate the 30th anniversary of our B-2 Spirit, the world's first stealth bomber, we continue to perform well on the B-21 radar, our nation's next-generation stealth bomber. Last month the then acting Secretary of the Air Force, Matt Donovan noted that the development program is on schedule and production will occur in Palmdale, California.

At Mission Systems, our IBCS Systems successfully intercepted a cruise missile at an extended range with Sentinel and Patriot System. The flight test demonstrated the value of IBCS to detect, track and engage low-flying threats at a distance well beyond the range limitation of the current Patriot System. In August, Innovation Systems submitted our proposal for the National Security Space Launch, down-select, which is currently planned for the third quarter of 2020. Our OmegA vehicle is on track to meet the customers' requirement for a first launch in 2021 and operational launches of national security payloads in 2022. On GBSD, we have assembled an exceptional nationwide industry team, that is ready to meet the Air Force's technical and schedule requirements. We are successfully executing on the TMMR phase of the program and we look forward to submitting our proposal for the next phase of the competition. The Air Force has been clear that our nation urgently needs to modernize the ICBM System, and that it is critical that this acquisition remains on schedule.

Turning to the US defense budget. We're now working under a continuing resolution that expires on November 21st. More often than not, we begin each fiscal year under a CR and we don't expect this to cause a significant disruption to our fourth quarter activities or our outlook for next year as long as there is not a prolonged CR. Our customers need predictable funding that is not constrained by continuing resolution limits. This enables investment in the critical technologies we need to stay ahead of rapidly advancing global threat. We believe our nation's leaders will provide the necessary resources to modernize key capabilities and therefore we are hopeful that the government will act quickly to finalize appropriations.

In closing, based on a solid quarter, strong year-to-date performance and our outlook for the remainder of the year, we are again increasing 2019 earnings per share guidance. We now expect mark-to-market EPS will range between $20.10 and $20.35. We are maintaining our sales guidance of approximately $34 billion, and we are updating our free cash flow guidance by raising the bottom end of the range by $100 million. We now expect free cash flow of $2.7 billion to $3 billion for the year. Regarding the 2020 outlook, we will provide detailed guidance in January. We expect mid-single-digit sales growth in 2020, which now includes the impact of the Lake City contract winding down in the latter part of the year. We also expect segment margin rates consistent with 2019 and strong and growing free cash flow.

So now, I'll turn the call over to Ken for a more detailed discussion of our financial results and guidance. Ken?

Ken Bedingfield

Thanks, Kathy, and good afternoon, everyone. I also want to thank the team for another solid quarter. We had excellent awards, strong book-to-bill, and higher sales at all four sectors. Year-to-date awards support our outlook for continued top-line growth. And as Kathy said, we are tracking to our segment margin rate guidance.

Turning to the sectors. Aerospace Systems sales rose 5%. Higher manned aircraft reflects volume increases on the E-2D and F-35 programs. Space sales also increased reflecting growing activity on next-gen OPIR programs. Autonomous Systems sales were also higher due to volume increases in multiple areas, including Global Hawk. AS third quarter operating income declined to $324 million and operating margin rate was 9.4%. This was driven by lower net favorable EAC adjustments. AS had fewer favorable adjustments this quarter primarily due to timing. We also had negative performance adjustments on two activities. The B-2 Defensive Management System Modernization program is experiencing schedule delays. Although the upgrade has taken longer than planned, installation of DMS has been completed on the first test aircraft and aircraft checkout is underway. AS has now completed most milestones on the program and are well along toward completion. We also experienced production delays for certain commercial space components.

We have introduced new leadership and processes in this business in order to successfully complete these contracts. In both cases, we believe our current EACs have captured the cost to complete the required work. Excluding these two adjustments, AS third quarter margin rate would have been in the mid 10% range. We continue to expect AS sales for the year in the high $13 billion range. We are maintaining operating margin rate guidance of mid-to-high 10% with a bias toward the lower end of the range.

At Innovation Systems, third quarter sales rose 12% in its first full quarter comparison. In Space, we had higher volume on national security satellite systems. Defense Systems had higher volume on precision munitions, armaments and tactical missiles, including the AARGM-ER program. Flight Systems had increased volume on military and commercial aerospace structures. IS operating income increased 2%, reflecting higher sales. Operating margin rate for the quarter was solid at 10.4%. The prior year period benefited from favorable indirect performance and the recovery of an insurance claim. Year-to-date, operating margin rate is 11.1%. For the year, we continue to expect IS sales of approximately $6 billion with a high 10% operating margin rate. No change to prior guidance.

Turning to Mission Systems. Third quarter sales grew 4% and operating income was comparable to last year. Advanced capabilities had higher volume on marine programs. Cyber and ISR had higher volume on space and restricted programs. Sensors and Processing had increased activity on airborne radar and electronic warfare programs, including F-35 and radars [Phonetic]. Based on year-to-date results, we continue to expect MS revenue to grow to the low-to-mid $12 billion range. And we are raising margin rate guidance to the low 13% range. At Technology Services, sales rose 3% and operating income rose 23% with an operating margin rate of 12.7%.

As we discussed last quarter, program headwinds are moderating and we are now seeing the underlying sales growth in both TS businesses. Operating income benefited from a focus on cost reduction, as well as a favorable adjustment on a sustainment program. We continue to expect TS sales in the low $4 billion range, no change to prior guidance. And based on strong year-to-date performance, we are raising guidance for TS operating margin rate. We now expect a high 10% range versus prior guidance of low 10%. As we roll all that up, we continue to expect 2019 sales of approximately $34 billion with a total segment operating margin rate of approximately 11.5%. Below segment OM, we continue to expect unallocated corporate expense of $225 million. Unallocated corporate expense is typically higher in the fourth quarter and our guidance contemplates an estimate for state deferred taxes and year-end accruals.

We are increasing our guidance for total operating margin rate to approximately 11%, largely due to updated cash pension estimates as we completed our annual demographic study. The presentation materials we posted this morning include updated estimates for CAS, net FAS/CAS pension adjustment and required funding for 2019 through 2021. Our 2019 estimates do not include the mark-to-market adjustment we will be recording in the fourth quarter.

2020 and 2021 estimates are based on year-to-date trends and assume a discount rate of 3.31%, 12% planned asset return in 2019 and 8% planned asset returns thereafter. Through September 30, our actual returns were about 14%. I'd also note that our CAS prepayment credit approximates $2 billion. The demographic study increased 2019 CAS and net FAS/CAS adjustment by $60 million. For 2020 and 2021, our updated assumptions increased net FAS/CAS adjustments by $140 million and $80 million respectively. And over the three-year period, our required funding is about $100 million lower.

Moving to taxes. Our effective tax rate for the quarter was 11.6%. Based on year-to-date results and our updated fourth quarter analysis, we now expect the tax rate in the low 16% range for the year. Wrapping all that up and considering year-to-date results, we are increasing our mark-to-market adjusted earnings per share guidance to a range of $20.10 to $20.35. This continues to be based on approximately $170 million weighted average shares outstanding. Free cash flow increased $352 million in the quarter. Year-to-date, we've generated more than $1 billion in free cash flow. Based on year-to-date results and our fourth quarter outlook, we are raising the bottom end of the free cash flow range by $100 million.

We now expect $2.7 billion to $3 billion for the year. We continue to expect capital expenditures of approximately $1.2 billion, as well as share repurchases of approximately $750 million. And as planned, we retired $500 million of debt in the third quarter. Beyond this year, we expect growing cash flows driven by higher sales and earnings, some improvements in working capital and modest required pension funding. Regarding capital expenditures, we continue to invest in growth opportunities as robust backlog growth continues. We are still targeting capex at about 2.5% of sales in 2021.

In summary, we had a solid third quarter and we expect strong results for the remainder of the year. I think we're ready for Q&A. Todd?

Todd Ernst

Erica, we're ready for questions.

Question-and-Answer Session

Operator

[Operator Instructions] Your first question comes from Peter Arment with Baird.

Peter Arment

Afternoon, Kathy, Ken, Todd welcome.

Ken Bedingfield

Yes, thanks.

Peter Arment

Kathy, thanks for the -- all the details on the realignment. Could you maybe give us just your thoughts on, sometimes when you do a realignment, you do shine a bright light on something that doesn't fit. Is this going to result in any portfolio shaping and just any updated thoughts on that? Thanks.

Kathy Warden

Yes, thanks for the question. And you're absolutely right, as we did this realignment, we've looked in depth of what we had in the portfolio to ensure that we were getting things aligned in a way that would create the most value for the company going forward. And I'm really pleased with the structure we're putting in place, it seizes the opportunity that we knew we had in space to bring the portfolio together in the new Space sector. I'm also excited about the creation of the Defense Systems sector, as it brings together some of our munitions and integrated air and missile defense capabilities in a tighter way along with our sustainment strategies, which deal with customers' very quick-turn requirement.

So, this has really been about the forward look in our company and seizing those opportunities that exist. And as we did shine a light on the whole of the portfolio, there wasn't anything that didn't fit within the structure that we created. But, of course, I continue to look at that on a regular basis and as we execute the strategies that we defined in this newer realignment, we'll continue to assess just that question.

Operator

Your next question comes from Ron Epstein with Bank of America Merrill Lynch.

Unidentified Analyst

Hi, good afternoon, everyone. This is Kristine [ph] dialing in for Ron today. And -- yes. I just wanted to follow up on the B-2 Defensive Management System Modernization effort. Are the operating issues you're facing there related to the re-baselining of the program, and then also, should we expect lower margins in this program to continue to your B-2 contracts going forward or is this issue kind of a one-time thing?

Kathy Warden

So, Kristine, I'll start and then hand it over to Ken to talk about the financial implications of what we saw on B-2 this quarter. We are managing thousands of contracts across the company and delivering very strong performance. And sometimes contracts are re-baselined as we did report earlier in the year, the B-2 program. What we saw this quarter was an adjustment there that Ken outlined in his comments related to the performance on that program. We feel very good about where we are in completing major milestones on our way to finalizing and executing the B-2 program. It is complex to update a system of that type, but we now have our arms around those challenges. So, I'll turn it over to Ken to talk a little bit more about the financial implications.

Ken Bedingfield

Thanks, Kathy and Kristine, I appreciate the question. Let me just say that, as I mentioned in my comments, we do believe that our EAC reflects the cost that we think will be required to complete the program. And as we look at our portfolio and I'll just go back to Kathy's comments, a portfolio of many different programs and contracts across not just the

Aerospace sector, but across the company. We don't expect this program as it will book essentially a lower margin from now until completion to have any material impact on our overall segment margin rate at either AS or in total for the company, again, given the very diverse portfolio that we manage on a day-to-day basis.

Operator

Your next question comes from Seth Seifman with JPMorgan.

Seth Seifman

Hey, good morning. Thanks. Ken, maybe if you could talk about -- you mentioned repaying some of the debt. When you look out beyond this year, there's some debt coming due each of the next couple of years. Can you talk about the approach that you plan to take there?

Ken Bedingfield

Sure, Seth. I would say as we look forward, we do have debt coming due. We also have a growing EBITDA as we look at growing the business, growing the top-line and maintaining strong margins, and that growing EBITDA gives us some naturally deleveraging there. So, as we look at that, I would say, we've got some optionality on what to do and depending on the value-creating opportunities that we see in front of us will very much shape what we do in terms of that debt repayment strategy, and we'll continue to evaluate what are the most value-creating uses of our capital and that will really shape it.

Operator

Your next question comes from Sheila Kahyaoglu with Jefferies.

Sheila Kahyaoglu

Thank you. Good afternoon, Kathy and Ken. Kathy, you made some preliminary comments on 2020. Can you talk about your comments regarding margin mix and having it consistent or margins being consistent, can you talk about mix within the portfolio, how you see it transitioning from mature to development programs, if you could give some color?

Kathy Warden

So, we'll be giving detailed guidance in January in our new structural alignment, but my comments did apply to the company as a whole seeing our segment operating margin rate stay consistent with 2019 guidance. And as we look at what's happening within our segment operating margin rate, we are taking on additional development work and there is some downward pressure on margin rates as a result, but we're also having very good cost management, which is offsetting our rates and allowing us to keep both competitive rates to win new business, but also healthy segment operating margin rate, and we expect that trend to continue into 2020. So, it's like a duck on water. While we're remaining consistent, there is a lot happening beneath to keep the margin rates consistent even as we take on additional development work.

Sheila Kahyaoglu

Okay, thank you.

Operator

Your next question comes from David Strauss with Barclays.

David Strauss

Thanks, good afternoon, everyone. Wanted to -- on the mid-single-digit sales growth guidance, Ken, you had been hinting potentially something higher than that on the last call, I know you talked about Lake City. How much does Lake City's -- was Lake City kind of the only change versus what you said prior and how does that impact things in '20 and I guess in the '21 as well? Thanks.

Ken Bedingfield

Of course. Yes, as we look at our sales growth for 2020, really Lake City has the biggest impact that we see versus the previous outlook that we had provided. We look at Lake City as probably having about a 1% impact on what we had expected for 2020 sales. And certainly, as we look forward, we see -- again, after the Lake -- after Lake City coming out, mid-single sales growth, solid margins and then again that growing cash. So, we're looking forward to performing on the existing portfolio driving that growth and turning that into margin cash.

Operator

Your next question comes from Rajeev Lalwani with Morgan Stanley.

Rajeev Lalwani

Hi, good afternoon. Ken, a question for you just coming back to the couple of comments you made on cash. I appreciate the color on easing capex and improving working capital. Can you maybe take it a step further and give us an idea of what conversion looks like over the next few years and maybe in 2021 and in particular given your comments there on capex levels?

Ken Bedingfield

Sure, Rajeev. Let me first comment -- from a conversion perspective, I would just say, you really need to be careful as you think about conversion for a number of reasons. I mean, first of all, the pension impact, as well as the amortization of PI and things like that. So, let me really focus on kind of how we're looking at cash and as we look forward to 2020 and beyond, we'll provide detailed guidance in January and walk you through all that. I'll just say that we've been clear that this business is going to be a strong generator of cash as we look forward.

And let me just kind of walk through some of the drivers there. As I said, we continue to expect solid sales growth for several years and that's really driven by our portfolio alignment to customer needs. And I would say it's demonstrated by the strong backlog that we've been generating and quite frankly, we continue to expect to generate in Q4 and 2020. And as I mentioned, we continue to expect to generate strong margins and convert those margins into cash.

Rajeev Lalwani

Yes, that's what he asked just about kind of taking an [Phonetic] answer, do you want to say it or just kind of ...

Kathy Warden

Well.

Ken Bedingfield

Erica, can you mute the other line, please? given our confidence -- given our confidence on our expected 2019 cash performance, we did increase the bottom end of the range, as Kathy mentioned to $2.7 billion, and we continue to be confident on our 2020 free cash flow growth. So, as we've been investing in the business to drive growth and a lot of that investment at AS, where we've grown the business 30% in three years, and at IS, that will grow double-digits in 2019, we continue to expect about $1.2 billion of capex this year or about 3.5% of sales.

And looking at 2020, we expect capex to be in the range of 3% to 3.5% of sales as we trend down to the 2.5% range in 2021. And I'd just say these investments continue to support our growing backlog and a robust set of near-term opportunities across multiple domains, including restricted space. So, just moving on from capex, again, pensions are well funded, some of the best funded plans in the industry, and that offers us structural advantage in our new business captures. Working capital as I mentioned, should moderate a bit starting in 2020, a bit more opportunity probably in the out-years, some of that being timing of cash receipt milestones and some of that continued focus on solid working capital management.

Operator

Your next question is from Doug Harnett with Bernstein.

Doug Harnett

Thank you, good afternoon. I want -- I wanted to understand a little bit better the growth trajectory in -- on the AS side, and if you look at the elements of this, I mean, you have F-35, clearly, there is some restricted space growth, but on autonomous systems in the release you refer to Global Hawk, but when we look at autonomous systems, it looks heavily biased toward Hail Systems, and those appear -- appear to be somewhat episodic in nature, I mean, on Global Hawk, NATO AGS, Triton. Can you talk about how we should think about this as more of a long-term trajectory with autonomous platforms?

Kathy Warden

Yes, Doug. So, as I think about the opportunity for unmanned systems, we've clearly seen some adoption for unmanned in applications like intelligence, surveillance and reconnaissance. As we look into the future, we believe unmanned systems will be utilized for more missions and we also see the opportunity for more international sales of unmanned systems as export regulations are considered and perhaps addressed to allow more of its capability to get into the hands of our allied nation. So, when we think about UAS under over a long-term trajectory, we see a continued evolution of these platforms into additional mission, we see them continuing to evolve in terms of their technical capabilities and these are the areas that we are investing in as a company. Today, there's everything from remotely piloted to truly autonomous systems, as you know, we tend to operate on the high end of that sector and we believe more missions will continue to evolve to that higher end capability as well.

Operator

Your next question comes from Myles Walton with UBS.

Myles Walton

Thanks, good afternoon. Kathy, I know that in the -- Kathy in the 10-Q, you alluded to the FTC disclosure specifically as the rates of the competition for GBSD. I'm just curious in your conversations with the customer, how they may or may not view this as an impediment to kind of bids being received, which I guess have a December -- mid-December is I guess the timeline for that?

Kathy Warden

Yes, thanks, Myles. So, we did indeed receive an inquiry from the FTC, and I want to note that we've been working with the FTC and the Department of Defense to ensure our compliance with the FTC decision in order that were -- that governs our ability to enter into the transaction of acquiring Orbital ATK and we're going to continue to do so. This is just a more formal inquiry that we are responding to as part of this latest request and that's why we disclosed it in the Q.

With regard to the GBSD competition, we haven't seen any changes regarding the RFP process since the [Phonetic] final RFP was released this summer. As you know, we have established a nationwide team and it's ready to go in meeting the Air Force's technical and schedule requirements for the competition. So, we're looking forward to supporting and submitting our proposal in December, and we've had no indications that there will be any change to the acquisition strategy at this point, and both the Department and the Air Force has made statements as recently as this week about their support for the program.

Operator

Your next question comes from Carter Copeland with Melius Research.

Carter Copeland

Good afternoon, team. Kathy, I just wanted to ask about more broadly program performance. I mean, this is I think the only -- only the second quarter I can recall on a decade, where there were more than one negative performance call-out, and I just -- I think the last one was a little more than a year ago. So, I just wanted to make sure there is not some sort of trend here that especially, with the realignment, you guys will have some stuff moving around, and I wonder as we go through that, if you can just talk about your confidence level that you have that other stuff may not emerge as you go through that process because it's got a lot of complexity and you guys are managing a lot right now. So just broadly, if you could speak to program performance, I'd appreciate it?

Kathy Warden

Yes, thanks, Carter. As I look at our program performance, it continues to be very strong. I'm particularly proud with some of the large development efforts that we've undertaken, as well as our ramp on major production programs that we are delivering on those very well, you've seen some public statements by our customers about how pleased they are with our performance on some of those, so I won't rehash them here. But every year, we do have a small number of programs that require negative EAC adjustments based on performance out of the thousands of contracts that we're managing and sometimes the timing of those adjustments causes a particular segment's operating margin rate to fall below our expectations in that quarter.

You're referring to that this quarter with AS and a little over a year ago with Mission Systems. But as you've seen over time, our performance management has remained strong and we're yielding good margins as a result of these circumstances being few and far between and fairly isolated. So, that was the case that you saw in AS this quarter. I'll also note, we had positive EAC adjustments that delivered to both expected segment operating margins and that happened in TS this quarter and is driving the increase in segment operating margin guidance at both MS and TS for the year. So, performance overall is still very strong in our company, and as a result, we're continuing to hold our guidance for the year on operating margin performance. Carter, if I could just add, I would say that in terms of the items that we called out this quarter, we were really trying to indicate what was the trend between last year's third quarter and this year's third quarter and help you understand the movement there as opposed to trying to identify the two items as having a longer impact on our performance. So, really it was a comment with respect to just the trend between Q3 '18 and Q3 '19.

Operator

Your next question comes from Robert Spingarn with Credit Suisse.

Robert Spingarn

Hi, good afternoon. I wanted to turn to -- hey, guys, I wanted to turn to TS, especially since we really won't be able to see it in the future, but it seems like under the hood, it's accelerating here with high single-digit growth to the US government, double-digit growth internationally. And since the headwinds are dissipating here in Q4, could this business despite the -- in its old form, for example, see mid-to-high single-digit sales growth next year if we thought about it in its present form because I think that's going to be a little bit obscured, so I'm curious?

Kathy Warden

So Rob, certainly, this year we have worked to reposition TS to be more competitive, that's been some good cost management, it's then rebuilding a stronger pipeline, and I'm really proud of what the team has done there and you see in the third quarter, a return to growth year-over-year and a strong operating margin. I believe that can persist and as we said, we do expect this to be a growing segment of our business in 2020. I would not go with far to say high single-digits, I would see it more in the low-to mid-single-digits, it is on a bit of a ramp and we still have some VITA burning off through the remainder of this year. So, that would be my macro outlook, and I'll hand it to Ken for any other comments he wants to make.

Ken Bedingfield

Yes, let me -- I guess, what I would say is, just to kind of frame up TS for the quarter and just to make sure we're all on the same page. We did see 3% growth at TS quarter-over-quarter, and I think you might be referring to in the schedules in the footnotes, there were some higher sales to the US government as opposed to some inter-segment sales and we've been working at TS to make -- essentially for TS to be the prime on certain international programs and particularly, International Hail and some others, where they were previously a sub to AS. So what you, I think are seeing somewhat there is, they are priming some of those programs that are some FMS, some through the US government as well, there were some B-2 work, where they were previously through AS, where now they are the prime.

But as we look at it at a top level 3% growth this quarter. We look forward to the continued growth of the TS sector in 2020 as it's a part of the Defense Systems. But broadly, we would -- wouldn't necessarily see it in that, that high single-digit range that you -- high single-digit range that you were referring to. I think some of that is just movement in the different parts between -- in our segment and the prime work.

Operator

Your next question comes from Noah Poponak with Goldman Sachs.

Noah Poponak

Hi, good afternoon, everyone. Ken, just going back to the segment margins for 2020, I think you've talked about the possibility of expanding margins modestly over time here, because you've mixed down a bunch over the past few years and maybe have hit a floor in that mixing down. And in 2020 you'll be -- at AS you'll be now comping against this -- the issue in this quarter hopefully not repeating it, Lake City out, I think helps the margin compare. Mission Systems is your largest earnings contributor and highest margin segment and I think may grow the fastest next year, actually, would love to hear your thoughts on that since that one's maybe not accelerating as quickly as we thought. But, so -- it seems like there are some margin uppers next year. Am I not appreciating how much development or classified work is still coming in or should we be thinking about flat as a floor with some upside potential?

Ken Bedingfield

So as we look at 2020 margins, I would say, first of all, as we think about 2019, we are essentially for the full-year still projecting where we expect it to be for 2019 from a segment margin basis, and each of the sectors is consistent to where it's been with the exception of TS, where we're looking at that increasing. You had some questions about AS and I would say, again, their forecast for '19 is consistent with where it is today.

And -- so I don't necessarily think of that differently from a Lake City perspective, certainly, we don't see that as having a significant impact overall on the portfolio. And just kind of thinking through it, we're -- we'll provide guidance in January when we get to that point. We certainly will work in 2020 to continue to perform on our portfolio and see the ability to drive up those margin rates as we work through the year and we've tried to do in the past, but we do continue to have some early-phase development work in particular, IS has some early-phase development work in the restricted space area or in the national security space as we call it. And that will be one of the drivers to what you will see, I think to your question about the fastest grower what I think you will ultimately see as the Space sector as the fastest grower in 2020. But again, we'll provide more detail and guidance when we get to the January call.

Operator

Your next question comes from Jon Raviv with Citi.

Jon Raviv

Thank you. Just following up on margin question in 2020, but a big -- bit bigger picture. Ken, you -- Ken, you started talking about the IS classified being some of the pressure there, can you just identify some other areas of the business that are seeing more of that development pressure? And then on a related note, is there something different about the development that you're doing today versus what you're doing maybe a few years ago that might be putting a little more pressure on early-on rates perhaps anything to do with contract structures requiring more risk upfront or anything like that? Thank you.

Ken Bedingfield

So, as we look at it, I don't see anything different honestly, Jon, with respect to what we're doing today. I mean, simply when we start in the early phase of a long development program, we're identifying the risks and therefore we're tending to book a lower rate as we try to burn down those risks over time. So, no change in how that's worked over the years. I think the biggest change being that we're seeing more opportunities for early development growth. And those are opportunities that we're more than willing to take on, and those will lead to those next-generation production programs that will provide that additional opportunity for margin expansion down the road.

So, I don't see any change. I mean, as I think about some of the restricted programs, they may not be multi-year awards, but many of them are multi-year in periods of performance. And so we're just managing risk over that long-term period of performance and again trying to create those opportunities as we look forward.

Operator

Your next question comes from Cai von Rumohr with Cowen and Company.

Cai von Rumohr

Thank you very much. Maybe going back to Myles's question, the FTC investigation. Do you expect it to have any impact on when the GBSD decision might be made and roughly when might that be? And have you had any pressure or kind of suggestion from the customer that maybe you might consider the national team proposal that Boeing has made?

Kathy Warden

So, Cai, we do not currently expect any change to the Air Force acquisition strategy as a result of this inquiry. They do you plan to award next August, so there is some time. Our proposal is due in December, and so obviously we will continue to monitor that, but right now, we do not see any impact. And in terms of the question about any pressure, we are not receiving any pressure to engage in a national team, because I would point out that we do have a, what we're calling nationwide team that includes many large and small companies across the country, who are bringing strong capability that will support our GBSD bid.

Operator

Your next question comes from Richard [ph] with Buckingham.

Unidentified Analyst

Thanks. Kathy, Ken, Todd, good afternoon. How are you?

Ken Bedingfield

Good. How are you, Rich?

Kathy Warden

Well, thanks.

Unidentified Analyst

So, an F-35 question with just a few parts to it as usual partly based on your opening remarks. So, the House and Senate fiscal 2021 mark-up has an increase in the F-35 quantities by 12 or 18 aircraft depending on which version you believe impacting I think Lot 14. So to the best you Ken as always, could you tell us what's being assumed in your 2020 guide for F-35 quantities? Now Kathy, you mentioned no disruption to your guide from the CR, but I wanted to know and maybe it's pressing you a little bit here. Is it possible that you could alter your guide depending on what happens in November when the CR expires and we potentially have a budget with possibly higher F-35 quantities, what do you think you likely captured all the -- all likely scenarios? And then finally, you've had enviable margins on the program, just wanting to know if that continues with the block buy? Thanks.

Kathy Warden

Great. So, I'll start with some of your more macro questions and then turn it to Ken on the quantity specifically. As I noted in my comments, we do not see an impact on our guide for a for a short-term CR. If we were to sustain a longer-term CR, that would impact to cause us to revisit our guidance, and I would include F-35 quantity in that statement. We have contemplated the possible quantities on F-35 changing through the appropriations process and feel that that's adequately reflected in our guide for '20 -- will be in our guide for 2020, because of course at this point, we've just given 2020 outlook. The other thing that I'll note is on F-35, we continue to focus on performing and driving down the cost curve and being a good partner to Lockheed Martin, but we also have opportunities on the program that are causing some growth for us over the next several years. One, of course, is increased sustainment work on the program, which I've spoken to before. And we're also seeing growth from the Block IV modernization program. We're working new development on our sensors specifically, radar, comms, navigation and identification sensors, and this will yield production opportunity in the long-term. So, we think lots 14 and beyond, and we have some production growth to support additional bearing with quantities increasing between lots 12 and 14. So, those aren't significant drivers. They're not nearly as significant as the production quantity itself, but those are some additional opportunities that we have in both the near and the longer-term on the program. And I'll turn it to Ken to add anything he'd like.

Ken Bedingfield

I think you -- you've nailed it there, Kathy. I would say, we certainly wouldn't want to go into the quantities that we've assumed for our 2020 outlook at this point, Rich, but we are continuing to perform on the program, proud of the performance that we've seen at both really at all of the sectors, who are supporting the program, supporting our customers. And we have continued to increase quantities and we'll see some continued ramp, and then Kathy kind of talked about what that longer-term profile looks like. So, I think that's -- that really captures it.

Todd Ernst

Erica, we have time for one more question.

Operator

Your final question comes from George Shapiro with Shapiro Research.

George Shapiro

Yes. You made a comment that Lake City would be about 1% sales impact next year, that says to me that you may still -- you may have Lake City for half of the year, because I would have thought the total impact would have been about 2% of sales? And then my second question is, how long does the current B-2 contract for which you took would look like a pretty sizable hit in the quarter last? Thanks.

Ken Bedingfield

Sure. Thanks, George. On Lake City, you are correct. We do have a transition from ourselves to the new provider of that service and so we will be performing on that program for at least the first half of the year for 2020. And so we will see some volume on that and the 1%, I was referring to was actually the reduction that we see to the previous outlook we had for sales, so, about a 1% reduction to our previous outlook relative to Lake City. From a B-2 perspective, George, I would say that I wouldn't want to comment extensively on the period of performance other than to say that, as I mentioned in my remarks, we're well along on program. We're making good progress. We're passing milestones. And I would just point out to your question about the substantial amount of the adjustment, I would just say that in regards to the adjustments at Aerospace Systems this quarter, neither one of them was in excess of $20 million. Again, we largely highlighted those as having an impact on the trend from our Q3 margin rate of 2018 to our Q3 margin rate of 2019. So, just a little color there for you.

Todd Ernst

Okay. I'd like to turn the call over to Kathy for final remarks.

Kathy Warden

Thank you, Todd. One correction from my commentary that I want to make sure I convey is the total backlog, not total restricted backlog growth year-to-date is 22%. So again, I want to thank our team for another strong quarter of financial and operating performance. We're executing well, building on our backlog for profitable growth and strategically aligned to our customers' highest priorities. And all of this provides us an exceptional platform for sustained value creation. So, we're focused on delivering a solid finish to 2019 and a strong start to 2020 with our new organization alignment. I look forward to updating you again in January and providing detailed 2020 guidance in that call. Thank you for joining our call today.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for your participation.