Good day, and welcome everyone to the Lockheed Martin Fourth Quarter 2010 Earnings Results Conference Call. [Operator Instructions] At this time for opening remarks and introductions, I would like to turn the call over to Mr. Jerry Kircher, Vice President of Investor Relations. Sir, please go ahead.

Jerry Kircher

Thank you, Karen, and good afternoon. I'd like to welcome everyone to our Fourth Quarter 2010 Earnings Conference Call. Joining me today on the call are Bob Stevens, our Chairman and Chief Executive Officer; and Bruce Tanner, our Executive Vice President and Chief Financial Officer.

Statements made in today's call that are not historical facts are considered forward-looking statements and are made pursuant to the Safe Harbor provisions of Federal Securities Law. Actual results may differ. Please see today's press release and our SEC filings for a description of some of the factors that may cause actual results to vary materially from anticipated results.

We have posted charts on our website today that we plan to address during the call to supplement our comments. Please access our website at www.lockheedmartin.com and click on the Investor Relations link to view and follow the charts.

With that, I'd like to turn the call over to Bob.

Bob Stevens

Thanks, Jerry. Good afternoon, everyone. For those on the East Coast, I hope you're digging out of the snowstorm satisfactorily and for all on the call today, I hope you're looking forward to a prosperous 2011 as we are.

I trust you've had the opportunity to read today's earnings release on our fourth quarter results. As the release outlined, operational performance in the fourth quarter continued at a solid rate and enabled us to achieve strong financial results, including over $20 billion in order bookings that expanded our backlog to over $78 billion while achieving sales growth of 5%.

We also continued to generate exceptional cash flow that provided the opportunity to repurchase a record level of over 13 million shares in the quarter, to pay dividends of almost $270 million and to fund $840 million to our pension trust.

This focus on operating cash has been a foundational element of our strategy to provide sustained returns through share repurchases and dividends, while still ensuring appropriate investments in the business, and that approach is working well.

Let me start with a very brief strategic update. Over the course of our last several calls, we've described to you our sense of this new reality that we're working in. One characterized by growing complexity in the global security environment and continuing pressures in the world's economy. All that we see reinforces this perspective, and is driving our actions.

As an illustration, just since we last spoke in global security, as our Defense Secretary visited on January 11, the Chinese showcased the pace of their advancement in low observable technologies with the J20 aircraft. In conjunction with previous demonstrations of anti-satellite systems, advances in communications and intelligence surveillance and reconnaissance capabilities, the development of antisurface ship weapons, the expansion of submarine capabilities and persistent cyber campaigns, questions about how China might use its expanding military strength are growing.

Also in the region, it's now estimated that North Korea will likely have an operational ICBM within five years, a prospect Secretary Gates recently called a direct threat to the United States, and one that only adds to the risks associated with an unstable and provocative government.

On the economic front, our nation's debt now exceeds $14 trillion, and the recently convened 112th Congress will soon need to address the prospect of increasing the debt ceiling as executive branch agencies contemplate overall spending reductions.

On January 6, Secretary Gates took a step in that direction by presenting a revised DoD future year Defense program, indicating that the President's budget request for government fiscal '12 for the base budget would be set at $553 billion, which represents about $13 billion less than the prior year's estimate but also about 3% real growth over the current continuing resolution, which is set to expire March 4.

The Secretary indicated the rate of real growth in the base defense budget will remain positive in government fiscal '13 and '14 and flatten out in government fiscal '15 and '16. Given the strength, the alignment and the quality of our portfolio, we expect to continue revenue growth through this period, and we continue to refine our strategy.

In parallel with the government efficiency drive, we've been executing a series of cost reduction and efficiency initiatives as well. Relative to our portfolio, we successfully completed the divestiture of the Enterprise Integration Group to Veritas Capital for $815 million in cash, and we believe we will likely have an agreement for the sale of our Pacific Architects and Engineers unit by the end of the first quarter 2011.

We continue to take out cost by reducing expenses across the board, particularly in travel, participation in air shows and the like, by carefully scrubbing our capital requirements, by tightening our organizational span of control and improving agility, through actions like the voluntary executive separation program and other measures and by focusing on consolidations to remove excess capacity, optimize facility utilization and efficiently balance our workload.

Most recently, we announced the phased closure of our Egan, Minnesota facility by 2013 and the movement of our contract work from Baltimore, Maryland to other company sites by 2011. While these actions are very difficult for our workforce and we undertake them with a measure of regret, they are necessary to meet the demands of this new reality that we're in. We'll continue to seize opportunities to reduce costs, increase productivity and drive affordability throughout our company and throughout the supply chain.

A significant component of our strategy is to focus on execution as improving quality and predictability while shortening cycle times not only lowers costs and assures that every dollar counts, it puts more critical security capability into our customers' hands sooner, giving them the tools they need to meet complex global security demands. We also recognize at this critical time of portfolio rebalancing, that it's essential to maintain our focus on cash generation and smart allocation.

Our desire to return at least 50% of free cash flow to investors in the form of share repurchases and dividends remains a top priority as does assuring that we invest in the technologies that will give our customers the edge in every mission area. While we're interested in acquisitions, we'll remain very selective, following our string of pearls model, meaning we look for acquisitions of an appropriate size to facilitate smooth integration, appropriate content to contribute to innovation and appropriate value leading to profitable growth.

We'll also continue to look at our pension trust relative to future funding needs. And finally, we'll continue to invest in our people to assure that we have the professional and leadership skills necessary to find success in the demanding environment that we face.

Turning to operational performance. I'll start with Aeronautics where two programs warrant special mention, the F-35 and the C-130J. On the F-35, we continue to see progress across key areas of the program. But like any development effort, challenges certainly remain.

In the flight test program, we completed 141 test flights in the fourth quarter, representing the highest quarterly level achieved to date as the tempo of flights continues to ramp up. For calendar year 2010, we exceeded our planned test goal of 394 flights by completing 410 test flights. But the STOVL aircraft remains the most challenging variant, with 212 flights completed. That's 39 flights behind plan. We're now working with our customers to finalize the test requirements for 2011. While the discussions are not yet complete, we are currently looking at about 872 flights in total. We've flown 36 flights so far this year, and we'll update you when the overall plan is final.

In the key area of software development, the STOVL variant flew with software block 1.0 for the first time in the fourth quarter. This software will serve as the foundational building block for all future avionics software on the F-35. It represents a key step in the process of validating our avionics system and ensuring that it operates in a way that gives our Warfighters a clear advantage over every adversary. Block 1.0 software enables information fusion from the radar, from the electronic warfare system, and from the electro-optical targeting system, and provides initial weapons release capability.

In his announcement of January 6, Secretary Gates identified the Air Force conventional takeoff and landing version and the Navy's carrier version, which represent over 85% of the planned domestic production run as proceeding satisfactorily in development. However, testing challenges and delays on the short takeoff and vertical landing variant resulted in his decision to decouple STOVL testing from the other models, to move the development of the STOVL aircraft to the back of the overall Joint Strike Fighter production sequence, and to place the STOVL version of the airplane effectively on probation.

These actions will better position the STOVL variant to demonstrate improved reliability over the next two years and get the Marine aircraft back on track in terms of performance, cost and schedule. We're completely committed to this course of action and very much appreciate the attention the F-35 is receiving.

Secretary Gates also outlined the recommendations of the technical baseline review, announcing the intention to add $4.6 billion to the F-35 development program over the next five years, extending development to 2016. These funds are to be used for additional development scope, for testing and risk retirement activities that better position the program for production, and to correct prior estimates.

The government fiscal year '12 production buy, our Lot 5 procurement will be budgeted at 32 aircraft, and the production ramp rate for future production launch was set at 1.5, meaning 150% growth in quantity lot over lot. Since the Lot 4 quantity recently placed under contract was also for 32 aircraft, the near-term flattening of lot to lot quantities, that's 32 aircraft in Lot 4 and 32 aircraft in Lot 5 does not support the planned cost reductions that are associated with lot to lot quantity increases and learning curve efficiencies. However, we do believe that with the total quantities of aircraft to be procured, we and our customers have ample opportunity to focus on overall affordability objectives, and we will.

Turning to the C-130J program, we continued to advance both with additional new business awards and increased annual production levels. The government of South Korea became the 14th country to select the C-130J with a contract for four new airlifters, bringing the total number of C-130J aircraft ordered since inception to 300. We also delivered nine aircraft in the quarter, bringing our full-year production to 25 airplanes, about 50% higher than our 2009 level. With a current annual production capacity of 36 aircraft, we have the ability to satisfy robust domestic and international demand.

In Electronic Systems, the team finished the year with a solid quarter across the portfolio. Noteworthy fourth quarter items centered on two areas: the Littoral Combat Ship and Missile Defense activities. In late December, the United States Navy awarded us a contract to construct the first of up to 10 Littoral Combat Ships through 2015, an award with an overall potential value of approximately $3.6 billion.

On the production front, our second vessel, the Fort Worth, was successfully launched in December and remains on cost and on schedule with more than 80% of construction completed. LCS was highlighted by Secretary Gates as a program deserving additional U.S. investment and in this new reality of tight budgets, will offer domestic and international navies a highly capable, cost-effective system.

In ballistic Missile Defense, we received a contract for over $900 million to provide Patriot missile defense systems to the United States, to Taiwan and to the United Arab Emirates, further expanding the global footprint of this proven system.

Additionally, the United States Navy awarded a contract to produce Aegis weapons systems for the DDG-113 destroyer with options for two additional destroyer systems. This contract also provides options for an Aegis Ashore system that will adapt the sea-based capability to a land-based system to protect the United States and allied troops in Europe against the ballistic missile threats.

Finally, operationally, the Aegis Ballistic Missile Defense System was used by the Japanese Navy to successfully intercept and destroy a target, further illustrating the capabilities of this fielded system.

Moving to Information Systems & Global Solutions. Our team achieved two key events in the quarter that deserve special merit. Under the $1.4 billion ten-year ID/IQ contract for the national airspace system integration effort, a contract known as NISC III, IS&GS will compete for task quarters to provide a broad range of information technology support to the Federal Aviation Administration. IS&GS will serve as the prime contractor in this effort and will build upon their prior experience under the NISC II contract.

I also wanted to congratulate our team on their successful completion and delivery of the 2010 census data for the United States government. This effort represents the successful processing of over 165 million census forms and is an essential tool used by our government to determine, among other things, the number of Congressional seats appropriate for states and the correct allocation of federal funds to state and local governments.

In Space Systems, the United States Air Force awarded a $1.4 billion contract for the fourth Advanced Extremely High Frequency satellite. This award expands the current contract from three satellites to four and follows the outline in last year's Quadrennial Defense Review to potentially award up to six advanced DHF Satellites.

Importantly, the Air Force announced that it intends to purchase satellites in block buys to lower the acquisition cost. We believe this approach is an exceedingly smart way to buy these systems in a fashion that will significantly contribute to affordability objectives, and we applaud Air Force leadership on this initiative.

Also in Space, our decades-long support of the Trident 2 missile continue to be recognized with an award of a contract for over $900 million to manufacture new missiles and provide related support services to this critical element of national security and deterrence.

Finally, I have described for you many times my admiration for the quality of our leadership and our workforce. I was very pleased to see five Lockheed Martin employees recently recognized as Fellows of the American Institute of Aeronautics and Astronautics. They are Dr. Ray Johnson, Mr. Frank Cappuccio, Dr. Stephen Engelstad, Mr. Jeffrey Hamstra, and Dr. Pradeep

Raj. They are exceptional leaders, and I was gratified to see their talent and contributions widely recognized inside and outside our corporation.

I'll turn the call now over to Bruce who will provide some additional detail on our fourth quarter financial results and our outlook for 2011. Bruce?

Bruce Tanner

Thanks, Bob, and good afternoon, everyone. As Bob outlined, our financial performance in the fourth quarter was both strong and broad based, and as I highlight our key financial accomplishments, please refer to the Web charts we included today.

Let's begin with Chart 3, our 2010 orders. Orders in the quarter were over $20 billion and were strong across all business areas. Most visible awards were the finalization of the F-35 LRIP 4 contract and the first of potentially 10 LCS ships. But you can see every business area has large awards in the quarter. For the full year, orders were nearly $47 billion, which represents the highest annual order level in our history. And I think this is a good indication of the alignment of our portfolio with the needs and requirements of our customer.

Turning to Chart 4, and a look at our ending backlog. We ended the quarter with a book-to-bill ratio of 1.6 and that resulted in growing our backlog by $1 billion during 2010 to our year-end level of over $78 billion. On the right-hand side of the chart, it's noteworthy to see the duration of backlog for a number of our major programs, particularly if you consider unexercised options that are beyond what's included in our current backlog amounts.

Moving to Chart 5, and our sales for the quarter. Overall, the corporation grew 5% in the quarter, with Aeronautics was particularly strong with 19% growth, driven by increases in both the F-35 and C-130 program sales. Electronic Systems performance was stronger in the quarter than we expected, resulting in the business exceeding the upper end of its guidance range for the year.

Overall, three of the four business areas showed growth in the quarter with Space Systems showing a decline due to the absence this year of several large milestone driven sales events that occurred last year.

Looking at our full-year sales growth on Chart 6. Total growth for the corporation was 4%. Aeronautics also grew the fastest for the year at 8% growth, followed by Electronic Systems at 6% and IS&GS at 4%. Space Systems was lower this year by 5% due to lower Orion sales and the wind down of external tank activities for the shuttle program.

Moving to Chart 7. Our earnings per share for 2010 was $7.18 from continuing operations, significantly higher than the outlook we provided to you in our last earnings call. The increase was seen in three main areas. Operational improvements, largely driven by the stronger performance in Electronic Systems resulted in $0.12 per share increase. Passage of the R&D tax credit provided another $0.12 improvement and other improvements in our tax provisions partially offset by the facility consolidation charge Electronic Systems and all other items netted to another $0.09 benefit.

Chart 8 is a summary of our cash generation for the year. As Bob mentioned, our cash flow was very strong this year, and we achieved a record level of cash generation of $5.8 billion before pension contributions, almost 25% more than 2009 levels.

As we outlined to you in October earnings call, we made over $2.2 billion in discretionary contributions to pension plans in 2010, bringing the funding level in our plants to over 80% as measured on a ERISA basis. At this level, our plans are sufficiently funded under the requirements of the Pension Protection Act to avoid any determination of the plans being turned at risk.

Overall, our cash from operations was $3.6 billion and in addition, we received over $800 million from the close of our sales at EIG business allowing us the flexibility to make both our pension contributions and continue our strong cash deployment practices, which brings us to our next chart.

Chart 9 highlights the significant level of free cash returned to our shareholders in 2010. Overall, we returned $3.5 billion, an increase of 25% more than 2009 levels. Share repurchases were $2.5 billion, more than 30% above 2009. Dividends returned almost $1 billion, reflecting the 19% increase in our quarterly dividend rate announced in October, which brought our annual dividend amount to $3 per share.

Chart 10 shows our share repurchase levels in the quarter and for the year. For the quarter, we repurchased 13.2 million shares, the highest quarterly level in our history and double the amount we repurchased last year in the fourth quarter. For the full year, we repurchased 33 million shares also the highest annual level in our history. The record level of share repurchases reduced our share count significantly as seen on the next chart.

Chart 11 shows the level of our share repurchase activities since 2005. We reduced over 7% of our outstanding shares in the year again, the highest percentage of share count reduction since implementing our repurchase program in 2002. The 346 million shares outstanding at the end of the year represents the lowest level in our history and reflect nearly a 20% reduction in share count over the last five years. And we have over $2 billion remaining in the share repurchase program authorized by our board in 2010.

Now turning to our financial outlook for 2011 as shown on Chart 12. As we discussed last quarter, we expect 2011 sales to grow at a low single-digit rate with segment operating profit remaining fairly flat with 2010 levels. We're now showing an improved FAS/CAS adjustment, primarily due to a higher discount rate than we assumed last quarter. I'll give more details on this change in an upcoming chart.

Earnings per share from continuing operations are projected between $6.70 and $7 per share, and I'm especially pleased that our cash from operations guidance has risen to $4 billion, significantly higher than what we've previously outlined. I should also point out that we are assuming at least $1 billion in share repurchases in 2011 and that our guidance assumes a timely resolution of the FY '11 Defense Appropriation Bill this year.

On Chart 13, we'll discuss segment guidance for sales and operating profit by business area. Aeronautics should have sales growth in the upper single digit range with operating profit projected to increase at a mid-single digit rate above 2010 levels, reflecting the ongoing transition from higher margin production fighter programs to the lower margin development and LRIP activities on the F-35 program.

In terms of phasing for the year, I'd expect sales to be heavier in the second half of the year as aircraft deliveries are planned that way. C-130 deliveries are likely to be weighted 1/3 in the first half and 2/3 in the second half, while F-16s will be about 40% in the first half and 60% in the second half.

Electronic Systems is expected to have slightly lower sales due to the completion of the persistent threat detection system activity last year. The delay the timing of awards such as LCS and FAS production, all of which are partially offset by growth in the SOFSA CLS contract.

Margins are expected to be similar to the level in 2010. Phasing of sales for Electronic Systems will be fairly consistent across the four quarters, trending slightly higher in the second half. IS&GS sales will be lower in 2011 due to the completion of the U.S. census work in 2010, while margins will be similar to what we experienced last year.

Sales will likely phase lower in the first quarter and first half due to the absence of the census program in 2011. Finally, Space Systems revenues are also projected to be flat compared with 2010 results due to the wind down of shuttle activity, offset by growth in satellite activities. Segment operating profit is expected to be down slightly due to the wind down of shuttle activity, and phasing of sales for the year should be fairly consistent across the four quarters except for the timing of two planned commercial satellite deliveries in the second and fourth quarters.

Looking now at Chart 14, as I highlighted earlier our FAS/CAS adjustment to earnings has significantly improved from our initial assessment in the last call. The new guidance for 2011 is a $925 million headwind on projected earnings rather than the $1.2 billion level we indicated in October.

Drivers of the improvement were discount rates increasing 50 basis points to 5.5%, higher than the 5% estimate we provided in October. Our actual return on assets was over 13% in 2010 versus our assumption of 8.5%; and with the largest swing in our FAS/CAS estimate resulting from the change in our discount rate, this highlights the sensitivity of our GAAP earnings to the volatility of rapidly changing interest rates, rather than the fundamental economics of our business.

Turning to Chart 15. You can see the significant year-to-year headwind, the increased pension expense creates on our EPS from continuing operations. Removing the FAS/CAS impact from both 2010 and 2011 shows growth in adjusted EPS of about 8% at the midpoint of our 2011 guidance.

In our final chart, Chart 16, I'd like to offer my perspective on how well Lockheed Martin is positioned within the industry and as a stock ownership opportunity.

As I see it, there are four key reasons why our stock represents good value proposition. First, we have a strong dividend yield of nearly 4%. Second, we have a strong history of consistent share repurchases, averaging more than 4% annual reductions in our share count over the last five years, and more than 5% over the last three years.

Third, while our cash generation over the past few years has been strong despite the large discretionary payments we made to our pension plans, those significant cash outflows will eventually swing to cash inflows as our reimbursements catch up to and surpass our required contributions.

And finally there's no program in the DoD budget that has the growth potential of the F-35 program going forward.

With that, I think we're ready for questions. Karen?

Question-and-Answer Session

Operator

[Operator Instructions] And our first question comes on the line of Rob Spingarn of Credit Suisse.

Robert Spingarn - Crédit Suisse AG

I have a Joint Strike Fighter question that is a joint question itself. I think it's for both Bob and Bruce. I wanted to ask you, Bob, you went through the restructuring alluded to by Secretary Gates back in the earlier part of the month. And the push to the right some of the timing on some of the lots, redirection of some funds into R&D, et cetera, and you talked about the fact that this is going to perhaps move savings initiatives toward the life of the program. It won't be able to target some learning curve-wise earlier on. So I'd like to ask you how we should think about Joint Strike Fighter revenue and margins over the four- to five-year period the Secretary was referring to relative to your earlier expectations?

Bob Stevens

So you have a sense of where we are in Lot 4 and while Lot 5 is proposed at 32 airplanes as is the typical process throughout the fiscal year, the Congress will review the request for 32 airplanes, and they will have deliberation if they will make a decision hopefully within the authorization and appropriation bill that supports the quantity to be purchased. When we think of overall pricing revenue of affordability, margins, we think that it will be exceedingly difficult on the affordability front to get near-term cost reduction opportunities without near-term volume increases, because volume increases are so intimately related to our ability and really, the industry's ability to drive down learning curves. So we're seeing a bit of a slowdown in the near-term ramp. We fully reflected our expectations in the near term in the 2011 guidance as we look forward learn more about the Congressional actions. We'll be sure to update our guidance accordingly and keep you well advised.

Operator

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

David Strauss - UBS Investment Bank

Bruce, a quick question for you. What is assumed in your guidance for share repurchases at this point?

Bruce Tanner

$1 billion.

Operator

And our next question comes from the line of Rick Safran of Buckingham Research.

Richard Safran - Goldman Sachs

I wanted to ask you about cash. So given that cash flow came in meaningfully higher in 2010 than you expected and given the strength of bookings, et cetera, does that kind of imply there may be upside to your $4 billion cash guidance and also as a kind of like a second part, just wanted to know what the current thinking is about dividends versus buybacks and by that, what I'm asking is there a potential here, for example, for more meaningful or higher dividend raises than we've seen previously?

Bruce Tanner

Rich, why don't I take a shot at this and see if Bob has anything to add at the end to it. You're right. Cash flow was very strong in 2010. I was particularly pleased if you take a look at all four business areas relative to what our expectations were as we entered the year, all four business areas exceeded those expectations. You may recall we were contemplating during 2010 some increase in our working capital throughout the year. We actually ended the year relatively flat, so we did not have that increase, and we were also expecting a slight increase in working capital as we headed into 2011, which we're now believing will be flatter still. So that, in particular, is what drove the cash higher in 2010 and gives us the confidence to increase the number to $4 billion in 2011. You talked about the orders. I was extremely pleased with orders again, $20 billion in the quarter, especially considering it's a quarter that's under continuing resolution. And the fact that, that led to $47 billion for the year, which is the highest level of orders we've ever had as a corporation I think is a testimony to the alignment of our portfolio with the requirements and needs, again, that the customer’s needs. And so if you're asking about the dividends versus buyback if there's a change there, we remain committed to the 50% return of free cash to shareholders as we've stated numerous times. Obviously, we have the firepower that we've demonstrated especially in the fourth quarter to continue the share repurchase and the dividend increase. We always revisit the dividends with our Board of Directors some time in the third quarter time frame of the year. We'll do that, again, this year and I think in short, Rich, we'll be opportunistic especially on the share buyback. And we'll revisit the dividend policy in the third quarter with our Board, which is what we always do.

Bob Stevens

Rich, I'll only add that we spend a significant amount of time focusing on cash generation because we recognize that is the single most significant source of our ability to run this business effectively and return value to investors. We like the balanced approach with our share repurchase program and our dividend increases that you've seen of us lately. I think if we're able to continue to generate cash flow in a superior fashion, we'd like to follow through with more of those actions.

Operator

And our next question comes from the line of Cai Von Rumohr of Cowen and Company.

Cai Von Rumohr - Cowen and Company, LLC

Could you tell us what you expect the tax rate to be for 2011 in a quarterly pattern? And secondly, you gave us a delivery pattern for your aircraft in 2011. But some times in the past, changes within a model from one customer to another have resulted in different margins. So should we expect that the aeronautical margins will start out low and get better as we go through the year? Is there any kind of visible pattern there?

Bruce Tanner

Yes, let me try to address the first question. First, obviously, Cai, tax rates we're expecting next year on a recurring basis are probably going to be about the 30% level. I wouldn't expect to see large changes quarter-to-quarter. I think that was part of your question as well. And I would not expect that. Phasing of the aircraft is going to be a little back-end loaded within Aeronautics. Again, as I said, for both F-16s and C-130s. I don't think, margin-wise, I'm trying to recall at the top of my head the quarterly spread of our margins within Aeronautics. I don't believe you're going to see a whole lot of changes other than I'll say the normal sort of risk retirement items as we progress down the production of all these aircraft. But from a planning perspective, from a guidance perspective, I don't see that, that I'd point out to you at this point in time.

Operator

And our next question comes from the line of Joe Nadol of JPMorgan.

Joseph Nadol - JP Morgan Chase & Co

Bob, the F-35 SDD contract is something I think I'd asked you about one or two of the past two to three quarters and I just want to ask again as to where you are.

My guess is that it impacted the margins here in the fourth quarter in Aeronautics, although that may have just been mix. But my guess is there's an SDD issue there. And it seems to me and I'd like your view on this as well, this may be sort of a sore spot in the relationship between Lockheed and DoD right now. So I know you don't want to take a bad deal, of course, but if you could just update us there on how you're thinking about it and where we are.

Bob Stevens

Yes, I will say that we started and finished the year in SDD at the same booking rate. So we can clarify that at the outset. There isn't really a sore point or sore spot in our discussions regarding the SDD program with the Department. Not about the opportunity for fee or profitability, it's all about focusing on assuring we're doing the right things at the right time to deliver three variants of the Joint Strike Fighter. And I honestly believe we see that reflected in the amount of time the Secretary of Defense has directly spent in reviewing and discussing the circumstances surrounding the F-35. For a Secretary of Defense to be literate and conversationally competent about the details of the technical baseline review is a significantly important thing to us, because we share a same goal. And the goal is to deliver this airplane as quickly as we can and as affordably as we can because when all of us look at the complex changes in the global security environment, we see an increasing need to have this airplane sooner for three services in the United States and certainly, for regional friends and allies who live in areas that have expanding difficulties. So there are not really contentious discussions here. They are full-throated views about how we should remedy some of the issues we're finding in the test program, but it's done professionally, it's done constructively. And I will say of all the observations that have been talked about that are developing in the system design and development phase, all the test areas that need correction, we're working cooperatively. Every one of those areas is being evaluated by subject matter experts in the government. Most of them have approved corrective actions in place and we're executing against those corrective action plans. And the ones that don't have them approved have them in development and review. So I think we're going to increase the momentum and the tempo of the program, including the flight test program, including software development. We're all steering towards the same course, and we all share the same objectives.

Operator

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

Douglas Harned - Bernstein Research

I want to continue on the F-35 because some of the statements that, Bob, you've made in the past and even today suggest that you think that you could go to higher rates than what the Secretary is talking about in the restructured plan. And what I'm interested in is understanding what is the source of that difference in views. And then also although I understand that you're ahead on both the A model and the C model in terms of flight test, what are the challenges you face there beyond just the number of flight tests to push this forward and be on schedule, I would say, on every aspect of this programs?

Bob Stevens

Well, let's talk about production capacity first. We've facilitized the Joint Strike Fighter line to accelerate at a rate faster than 1.5. That's true. And we've done that, in concert with our government customers, in full cooperation. I think the Department of Defense is providing their best professional judgment after, undoubtedly, one of the most thorough reviews that any program has ever had with the results of the technical baseline review. What is a prudent, near-term 1.5 escalation in quantity year-over-year. I'm sure in the future, that will be reviewed again based on our performance. We accept that 1.5 rate now. We have a lot of areas of interest that we have to go focus on. The F-35, I think it's important to remember when we're talking about volume now, we're talking about U.S. government volume, and the F-35 has an extraordinary international potential business base here. And expressions of international interest have been increasing. So I would submit to you, Doug, that if we're able to execute on a plan that allows everybody to build confidence and that certainly is our commitment, then just as we've had periodic reviews of the program to date that have resulted in some adaptations to the program, there can be similar adaptations increasing the ramp rate. We have an independent manufacturing review team that periodically looks at our manufacturing productive capability. And I'm sure they have been flexible and wise in their judgment thus far, and they'll be that way looking forward. You asked about the A model and the C model and the flight test program. We look at this, I think, in general terms in a couple of pieces. One is assuring that we're demonstrating the flying qualities of really all three variants and the STOVL variant is in the flight test program and it is showing signs of the improved performance, that's an area we're going to concentrate on intensely but it doesn't mean we lowered our concentration on the conventional version or the carrier version. There's also a software development program, and I think you know we're developing software in three blocks. The blocks have interim releases called A and B. We've released software Block 1.0. We continue to write the other software blocks. We have to synchronize the software block delivery with the capabilities being demonstrated in the flight test program so that we can continue to expand the envelope and continue to move these jets closer toward initial operational capability. And then there's another piece for preparation for training because the jets have to be inserted into a training program with pilots in a curriculum to also prepare them for the initial operational capability. So you can get a feel from this of why it is absolutely so vitally important for us to stay in lockstep with our government customers with the Joint Program Offices, with the services, with the Systems commands, who bring the engineering talent and the subject matter expertise forward. It is a large program. It does have complexity. But in that size and complexity, there's a lot of strength and experience and judgment that is all dedicated to getting this program right. We're very gratified for that level of cooperation. So there's a lot of moving parts. Sometimes they don't all move in exactly the way we want them to. But generally that movement is forward. We're showing progress, and we're going to continue to apply all the resources we have to make this a successful program.

Operator

And our next question comes from the line of Jason Gursky from Citi.

Jason Gursky - Citigroup

Just a quick bookkeeping question. All things equal, how will pension expense trend into '12 and '13 and then maybe just a clarification on some things that you've chatted about in the past, which is what you would view as full rate production on the F-35 program and the year in which we might get there and the level of revenues that one might expect once we reach full-rate production.

Bruce Tanner

Jason, I'll tackle pension question first. You asked about going forward in '12 and '13 and the way we always characterize it is if things don't change from current assumptions so kind of current course of the speed, the same discount rate and same long-term asset return rate 8.5% and 5.5% for the discount rate. I would expect that the FAS/CAS adjustment from some $925 million headwind in 2011 will drop very dramatically in 2012 being -- maybe think of it as maybe a couple of hundred million dollars or a little more maybe of headwind in 2012. And then I would think they would flip in 2013. So we've actually got a bit of a tailwind at that timeframe. Now all this is dependent upon and I'm trying to predict when this is going to happen, I've been unsuccessful with those predictions in the past but all this is predicated on when CAS harmonization occurs and its impact on the CAS recovery there. We are assuming when I say that, that will occur in 2012. And as far as full-rate production, I'm going to ask Bob to give some comments on that.

Bob Stevens

Yes, Jason, it's been a while since we talked about moving to full-rate production because our focus has been so much on the system design development and phase and Low-Rate Initial Production. But at the last time we had these discussions, we were looking at ramping up to the neighborhood of about 200 airplanes a year. We were talking in terms of about one a day. I don't see any reason assuming that we resolve the issues that are before us now and continue to execute and demand stays strong for the program, which we believe it will. That's probably the range of the neighborhood that we'll be looking toward. Relative to timing, we really need to have the jets proceed through initial operational capability before we get to those levels of full-rate production. That time line now is in the neighborhood of 2016 or so. The services are examining the dates that would be appropriate for their initial operational capability. So I think the short answer is in the 200-a-year range, and we don't go to full rate until after IOC and that date today is about 2016.

Operator

And our next question comes from the line of Ron Epstein of Bank of America.

Ronald Epstein - BofA Merrill Lynch

Maybe changing the subject a little bit away from F-35. On Littoral Combat Ship, you won the recent award domestically. Is there an export market for the vehicle and can you expound on that?

Bob Stevens

Well, we think there is an export market for the Littoral Combat Ship. The Government of Saudi Arabia has expressed some interest very directly in the performance characteristics of the ship, and they're looking to modernize their Eastern fleet. So there is a prospect there. We've had some additional, I'd say inquiries, as to the suitability of the Littoral Combat Ship. I think international customers want to get some more information about the vessel, and I think they were honestly looking to see what the award would actually look like in its final manifestation. And that award just took place at the end of December. The Littoral Combat Ship is the size and class of vessel that we think will be of considerable interest to many navies because most navies don't really have very substantial tonnage in their ships. And of course, the modular configuration of the ship, the ability to reconfigure it in near real time with different mission modules for different tasks, I think will have great appeal. And then as we look to the future, we'll look at evolving the ship's capability, for example, for ballistic Missile Defense capabilities and actually, we are interested in listening to potential customers as to how they might want to customize or reconfigure the vessel for very specific mission purposes. The ship was really built to have additional flexibility, small crew, high performance, use information technology wisely, and that allows us to reconfigure it and customize it in various ways. So I do think it will have some interesting international opportunities. We'll look for them and we'll be sure to keep you posted as these matters mature.

Operator

And our next question comes from the line of Myles Walton of Deutsche Bank.

Myles Walton - Deutsche Bank AG

First just a clarification, Bruce, on the FAS/CAS for '12, you're saying it's a $200 million FAS/CAS adjustment, not a $200 million headwind to the $925 million, is that right?

Bruce Tanner

Yes. Let me be more precise than I, obviously, was when I first answered. So $925 million headwind in 2011, and that's dropping dramatically to about $200 million headwind, not additive to the $925 million in 2012.

Myles Walton - Deutsche Bank AG

The real question I have is on, maybe for Bob, on the F-35. The STOVL production adjustment relative to the rates, relatively anticipated given the testing of your rebaselining there, but I'm curious how you think, how we should think about the Air Force's decision to cut its buy about 20%. And I mean, is this -- it seems like the testing was going well, it seems like the Air Force is rhetoric and strong. Just curious how we should interpret this.

Bob Stevens

Because I am sensitive to some of these discussions, I don't want to overly clarify your comment, the Air Force didn't cut the volume of their buy. They rescheduled the rate at which they'll acquire the CTOL, so the totals still look the same. I have great empathy for the Secretary of Defense and the leadership in the Pentagon, who are looking at load-balancing in a period of this new reality that they see, too. There are fiscal challenges that they face, there are security challenges they face. They are going to be compelled to do more without having more resources in given fiscal years, and I think they're simply trying to make the right decisions and balance their load. I'm absolutely confident that as we continue to make progress on the Joint Strike Fighter, including the conventional takeoff and landing version, when we demonstrate that the airplane can fly effectively, that we're burning down our test points, that we're meeting our flight test schedules, that we're delivering software on schedule and we're meeting the milestones in reparation for training, the Air Force strongly desires to begin to phase the Joint Strike Fighter into the inventory. I'm absolutely confident of that. I think I have the same confidence for the United States Navy, and I certainly have it with the United States Marine Corps. As I mean with the Commandant of the Marine Corps with some regularity, he is personally and substantially involved as a service chief in taking ownership and accountability for getting Marine aviation the F-35B version. He measures performance on a weekly basis. I couldn't ask for a higher level of partnership, and it’s circumstances like that, when we focus together with the same set of metrics, with great transparency on what we've accomplished and what we have yet to accomplish, that progress will be born. And so I'm really confident that we're going to be able to meet our milestones and as we demonstrate the milestones, there'll be greater confidence in the airplane and actions will flow accordingly.

Operator

And our next question comes from the line of Heidi Wood from Morgan Stanley.

Heidi Wood - Morgan Stanley

A sideline non-aero question for just a second. Can you give us an update on what your percentage of international sales were in 2010. And, Bob, highlight for us the major campaigns you see in 2011 and are you seeing international demand rising? Or is it flat vis-à-vis last year? Or are you seeing its tail off?

Bruce Tanner

Heidi, I'll answer the international sales question. We ended the year right about 15% sales going to international customers, and that's in line with what at least I have talked about in previous calls about trying to grow that amount over the next two or three years up to 20%. I think we're on a good path to do that, and I would think we will see that transition from where we are today about 15% to 20% ratably over the next couple of years.

Bob Stevens

And, Heidi, when we think of International business, we think there'll be greater opportunities there for sure. I mentioned in the remarks, when the call opened, some changes in the global security landscape that I think some people may have reacted to with surprise but not everyone. It's very clear that technologies continue to proliferate. Countries and individuals continue to make investments and sadly, the threats that people face have not diminished in their entirety. When we look at the maturity of our portfolio, the quality of our products and frankly, the reputation that we enjoy globally, say, in our Aeronautics portfolio with airplanes like the F-16 and the C-130J, and I believe the F-35 will take its position right alongside really venerable programs in aircraft like that. There's a very high level of interest in securing these kinds of assets, and I think individuals recognize as we increase our production rate, we lower our cost, our quality is good. When they're thinking of affordability, this is a very opportune time to think about recapitalization needs along those lines of business. With the proliferation of missile systems, Missile Defense capabilities become preeminent. We have the Patriot system. We have the FAD system. We have the MEADS system. We have the Aegis system including Aegis Ashore. These are very robust, very proven technologies. Individuals don't take a great deal of programmatic risk, and I think they get a great deal of protection. It seems to us that international opportunities will vary perhaps a little less so in Europe for perhaps obvious economic reasons, but probably more so in the Middle East and more so in the Asia-Pacific theater. We're concentrating our efforts there. We're getting substantial inquiries from those areas.

Operator

And our next question comes from the line of Sam Pearlstein of Wells Fargo.

Samuel Pearlstein - Wells Fargo Securities, LLC

I guess one other question, which just I think what where Heidi might have been going is, I don't know if there are specific campaigns you can highlight that we might be watching as we go through the course of 2011, and you had a pretty strong fourth quarter order rate. Do you think you'll be able to get a book-to-bill up at 1x as we look through 2011?

Bruce Tanner

Yes, let me talk about the -- Sam, if I could, this is Bruce. Let me talk about the phasing of backlog. Last year, we had -- I'll say that even distribution of orders across the four quarters, we actually dropped down to what, $71 million of backlog in the third quarter before we had the $20 billion in the fourth quarter. I think what we'll see in 2011 is a much more even spread, I mean, in fact as we're looking here the first quarter might actually end up a little bit even higher than where we ended the year. And then we may drop down a bit. Third quarter always seems to be our low point for the year, and I still think we'll end up the year either equal to or slightly higher than we ended the year 2010 with. And then, I'll maybe the start the bidding with the international opportunities and say, probably first and foremost, the C-130 sale to the UAE is likely going to be a first quarter, maybe early second quarter event. That'll be, think about a dozen or so C-130s. We're still hopeful that we can have some time this year some interest from the government of Iraq on an F-16 buy. And obviously – maybe not obviously - but one of the bigger ones we're counting on later in the year is the UAE FAD program. And I'll throw it over to Bob and if see he has anything else. Bob?

Bob Stevens

So, Sam, I would only reinforce those are the most active campaigns probably the UAE FAD is the most substantial with regard to Missile Defense.

Operator

And our next question comes from the line of Peter Arment of Gleacher and Company.

Peter Arment - Gleacher & Company, Inc.

Bob, could you give us an update on Lockheed Martin's portfolios shaping? You came into 2010 and you made some two significant announcements and it sounds like PAE is going to close very soon or at some point here in the first quarter, and I know when you're rolling up your 2011 plan, you'd take a very hard look at this. Could you give us an update on that?

Bob Stevens

Peter, we have taken a very careful look. We like the portfolio that we have very much. As I mentioned, we're always looking to acquisitions but they really have to pass some pretty stringent tests of adding creativity, innovation, capability that we don't have today, the right size, the right value. We look at a lot of prospective acquisitions. We don't pursue a lot of prospective acquisitions, and we're going to continue to be selective. On the divestiture side, we don't have anything else in queue beyond PA&E. We did a very thorough assessment that led to the divestitures of EIG and PA&E. I think our focus will be on assuring we run a very tight shop here. Cost reduction, and there is no area or no element of our cost structure that we will fail to look at to see if we can get efficiency improvements and productivity. Recently, we announced the closing of Egan, as I mentioned, and some repositioning work out of Baltimore. We'll continue to look at ways to optimize ourselves with respect to the portfolio internally. I will say, we very much like the portfolio that we have in an environment where global security demands are increasing, in areas where we have demonstrated expertise, where affordability matters and we know economically there are increasingly scarce resources. It is why we are so focused on assuring we have sufficient volume and program continuity to allow us to continue to drive down learning curves to give customers real value. So I would tell you today I really like where our portfolio sits.

Operator

Our next question comes from the line of Troy Lahr of Stifel, Nicolaus.

Troy Lahr - Stifel, Nicolaus & Co., Inc.

Bob, I'm wondering if you can talk a little bit about some of the -- you guys targeting adjacent markets. In the past, you've talked about that but you really didn't address it in your strategy discussion going forward, is there a less of a focus on that? Or does that just kind of fall into the acquisitions category?

Bob Stevens

No. Well, I thought the Littoral Combat Ship was representative of our interest in successful pursuit of opportunities in the adjacent market. And frankly, I don't talk about Littoral Combat Ship with adjacencies anymore because it's not. It's a core product line for our company, and that's how we build the core of the business and we're pleased with that. I will tell you that when we explored the market on the horizon for energy opportunities, we still have a keen interest in those areas, in cybersecurity, in health care information technology. Let me say our judgment about the quality in those markets is that it's maturing with some differential. A little slower than we anticipated, we think there are reasons for that deceleration. It doesn't mean our interest has diminished, but we're not going to lower our standards and pursue initiatives in areas where we don't believe we can be successful and I mean completely successful in delivering value to customers, running an efficient and good operation that we're proud of, that's good for our employees and generating the kind of financial returns that will more than satisfy our investors. I'll return to the quality of the portfolio that we do have. We believe we have a sufficiently strong and well-integrated core business portfolio here so as to continue to generate profitable growth from that core. We want to focus on generating cash. As we generate cash, it gives us considerable latitude to make wise investment decisions. We invest considerably in innovative technology inside our company, in business ventures with other organizations who bring value added either in the quality of their portfolio or their customer points of presence. And we have done that over the last year. I think of that as enriching the pipeline for future innovation and future opportunities. If we can't find acquisitions that make a lot of sense or investment areas in these adjacent or horizon markets, where we have high degrees of confidence that we're going to return good value to investors, we'll continue to pursue our share buyback program, our dividend program. We feel we have enough degrees of freedom to continue to generate economic value while we pursue superior position in the marketplaces. So we're going to build on the core portfolio that we have.

Operator

And our next question comes from the line of Howard Rubel of Jefferies.

Howard Rubel - Jefferies & Company, Inc.

I have a cash flow question that's sort of two parts. Bob, the first part of it has to do with sort of contracts and the terms and conditions that you're seeing. And then the second part of it, Bruce, is could you give us a little more detail on how you got to the $4 billion in operating cash flow? I realized that D&A is probably $700 million-plus and net it's probably $2.5 billion and so there's obviously, there's some working capital or some other items making a difference there.

Bob Stevens

Well, the terms and conditions, Howard, tend to orient around performance-based payments or progress payments on U.S. government contracts. There's been a little bit more discussion about shifting the balance a bit from performance-based payments to progress-based payments, I think we've seen that a little bit but not in any wholesale way. So our cash flow projections include the balance that we're experiencing and our projection of where that balance might go on those two cash-recovery mechanisms. I will tell you that a great credit to Bruce and the finance team. We spend a lot of time and focus and attention on refining the cash collection cycle here, and our focus on working capital but really focusing on demonstrating value. And when you talk about contract terms and conditions, it's important for us to work contract descriptions where customers know they're receiving value and can therefore, release the cash with confidence. And I think our cash generation capacity is reflective of the system that's working pretty well. I hope that answers the feel you wanted to get for the mechanics of cash flow, and I'll turn the balance over to Bruce.

Bruce Tanner

Yes. Back to your question on how we are getting to the $4 billion. I'd point to maybe two things that I see improvements on going forward. Some of which happened in 2010. As I said, I think some are going to carry over into 2011. One is as we start to see international contracts, back to Heidi's question on the level of International business we're doing, that will grow over the next two years, including 2011 and with that International business I think we'll see some customer advances coming to fruition. And secondly, the thing I'd point to is we've done I think a very, very nice job here recently in 2010 throughout the year. And I suspect we can still do a little better, particularly in the accounts receivable area, where I think in particular the IS&GS business area has had a tremendous focus on improving that. That's where a lot of -- just to be blunt, most of our other business areas tend to get most of their cash collections from a single payment office or a few payment offices within the federal government. Often times, that is the payment offices in Ohio. IS&GS has literally multitudes of payment offices because of their multitude of customers, and I think we've done a very good job of putting that kind focus on collecting those across that mixture of payment offices such that we're getting better returns and quicker payments of our cash than we previously were seeing, and I think that's going to continue into 2011. So I believe that those two things as the main drivers.

Operator

And our next question comes from the line of George Shapiro of Access 342.

George Shapiro - Citi

Two-part question. One, I wanted to know whatever happened to the $600 million process pool for the SDD program that was, I guess, reset to different milestones and then the second is, why in the LRIP 4 contract wasn't there a contingency put in there in case production rates didn't grow as expected, given that there was clearly some risks that, that would have happened in the budget environment that we're in.

Bob Stevens

Well, let me talk to first, George, about the $614 million. We still have not finalized the discussion on any perspective reallocation of the $614 million as it relates to an award fee pool for work done under the system design and development contract. Let me also add that when we contemplate the prospective addition of $4.6 billion in the over target baseline that Secretary Gates mentioned, and I say prospective because we just haven't worked that into the contract, yet. In so as far as that $4.6 billion relates to the extension of effort already under contract, it won't carry an incremental fee with it. The $614 million was an award fee pool beyond that $4.6 billion. It has not been allocated on milestones yet. I think that conversation will begin shortly as we fold in, the revised program plan, establish milestones and do this in a very discreet way. Conversations will conclude on the appropriate size of that pool and the allocation of that pool to specific milestones. I can't answer you with greater detail because we don't have greater details. As soon as we get it, we will describe it to you. On the second part of your question was on Lot 4 having a condition about the quantities in Lot 5. We don't believe the performance environment on Lot 4 is going to be adversely impacted by the quantity on Lot 5 and don't need provision in the contract as such.

Bruce Tanner

George, I'll add one thing to that. If you consider the growth that we're going to see on the SDD contract the $4.6 billion that Bob talked about, there will be some overlap obviously, and the cost profile of that SDD extension and the shortfall from the production contracts that will help to mitigate a lot of that impact on our LRIP 4.

Operator

Our final question for today comes from the line of Pete Skibitski of SunTrust.

Peter Skibitski - SunTrust Robinson Humphrey Capital Markets

Bruce, I just want to follow up with you on earlier question on out-year pension projections. Given we may have a $1.5 trillion deficit now, can you give us your out-year pension projections under the scenario where cash amortizations may be delayed a year or two?

Bruce Tanner

In terms of FAS/CAS, Pete, I'm not sure.

Peter Skibitski - SunTrust Robinson Humphrey Capital Markets

Correct.

Bruce Tanner

Again, we've talked about $925 million. I should have like Myles Walton answer this question. He's probably got the numbers as well as I do at this point. But with current discount rate and the current asset return, again, we think the FAS/CAS in '12 will go down to about a couple of hundred million dollars as opposed to the $925 million.

Peter Skibitski - SunTrust Robinson Humphrey Capital Markets

That's under cash harmonization actually happening, correct?

Bruce Tanner

Your question is, would CAS Harmonization happening.

Peter Skibitski - SunTrust Robinson Humphrey Capital Markets

Yes. What would be the net expense of cash Harmonization doesn't happen or it slides out a year or two.

Bruce Tanner

I think the impact of 2011 as I recall was about $100-ish million or so when we pushed CAS Harmonization out. My guess, since it's another year later, it’s probably a couple of hundred million dollars if it we were to push out from 2012. I tell you that's what I think we and the industry, we're going to be looking for that to happen. I think we've delayed that beyond what was originally contemplated when the Pension Protection Act was put in place. We were carved out very specifically, a large defense contractors as needing an adjustment to the CAS as a result of the PPA requirements, and that's one that I think as an industry and we, Lockheed Martin, will look to have coverage for in 2012.

Bob Stevens

Well, Karen, we've gone a little long on the call. Let me thank everybody for the additional time. Certainly thank you for your questions. We appreciate your thoughts. We're going to go focus on execution here, and we look forward to keeping you well informed as to the progress that we're making. Again, thank you for your time today. Karen, thank you.