Good day. And welcome everyone to the Lockheed Martin Second Quarter 2013 Earnings Results Conference Call. Today's call is being recorded.

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. Please go ahead sir.

Jerry Kircher

Thank you, Sahid and good morning. I'd like to welcome everyone to our second quarter 2013 earnings conference call. Joining me today on the call are Marillyn Hewson, our Chief Executive Officer and President; 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 Marillyn.

Marillyn Hewson

Thanks, Jerry. Good morning, everyone and thank you for joining us on the call today. Before I begin I want to offer my appreciation and congratulations to our Lockheed Martin team for their continuing outstanding performance and the achievement of strong second quarter financial and operational results. As we continue to operate in a dynamic and challenging environment, their efforts and focus have our Corporation poised for continued success in delivering value to shareholders and solutions to customers. While Bruce will cover the financials in more detail later, I'll highlight some key financial achievements from the quarter that included growing earnings per share to $2.64, 11% above last year's second quarter level, expanding segment operating margin to a record level 13.4% and achieving an increase of 110 basis points above last year's level and generation of $600 million in cash from operations after making $750 million in pension contributions.

Our continued strong cash flow is foundational to our cash deployment strategy to generate value to shareholders through share repurchases and dividend payments. In the second quarter, we repurchased over 4.5 million shares of our stock, more than double the 2.2 million shares we pre-purchased in the second quarter last year. We deployed $465 million for share repurchase through this quarter and paid slightly over $370 million in dividends. Through the first half of 2013, we returned over $1.6 billion or approximately 70% of our free cash flow to shareholders through dividends and share repurchases. Overall, I would characterize the second quarter financial performance as broad based across all business areas with results exceeding our expectations. This strong performance enabled us to increase our 2013 financial guidance for operating profit, earnings per share and cash from operations. Bruce will cover some of the specific drivers for the improved performance in his briefing.

Before discussing other achievements this quarter, I'd like to outline the status of DOD budgets. Since we last spoke in April, not much has changed in the budget environment. FY13 DOD budget appropriations have been enacted and incorporate the $37 billion in budget reductions required under sequestration. Our sum budget reduction actions are being implemented by the government, they have to implement most of the required spending cuts. To date, we have seen minimal impact to our portfolio programs with actions taken primarily limited to our shorter cycle business.

Customers are continuing to determine how they will implement the cuts mandated by sequestration, which they're required to do before the end of the fiscal year on September 30th. And we are working closely with them as they explore host of potential scenarios.

For FY '14, Congressional deliberations on the budget are continuing. The President proposed baseline defense budget remains at $526 billion without inclusion of the $52 billion in sequestration budget reduction that went into effect in March 2013.

The Department of Defense has finalized the Strategic Management Review that reexamined policy and program priorities to account for the sequestration imposed cuts. This review will be used to aide DoD and continuing to formulate decisions on post-sequestration program and budgets for 2013 and 2014.

Our future budget levels remain uncertain, the strategic need and support of number of our key programs such as the F-35 Joint Strike Fighter, missile defense systems, littoral combat ship and C-130J remains intact. We will continue to work with customers and respond the changes as required when budget positions are finalized by the government.

Turning to the operational performance, our five business areas continue to execute with exceptional focus and skill in providing critical products and services to customers. Of the numerous accomplishments in the quarter, I'd like to highlight our continued success in missile defense activities, provide a status of our expanding international work and finish with an update on the F-35 Joint Strike Fighter program.

First, with the growing threat of ballistic missile proliferation, the need for proven, reliable, interceptor systems is becoming more acute daily, providing defense system design to prevent the catastrophic damage that can be inflicted on civilian population centers and national infrastructure by offensive missile is essential to our nation and alliance.

Our portfolio of interceptor system consisting of Aegis, Patriot, THAAD and MEADS will provide layered coverage intended to defeat missile press post by world nations.

This quarter, our Patriot 3 missile conducted a ripple fire test that successfully intercepted and destroyed two different targets at White Sands Missile Range. This test was the first time a multi-target engagement was performed against both the Ballistic Missile Target and the Cruise Missile Target, and it success provide a clear demonstration of the design maturity and increasing capability of the PAC-3 configuration.

In addition to the Patriot test events, our Second Generation Aegis Ballistic Missile System successfully launched and guided a missile to engage and destroy a separating short-range Ballistic Missile Target. This test validated the ability of the Aegis system to engage increasingly more challenging enemy threat.

It also marked an important milestone for the phased adaptive approach to missile defense in Europe. This approach will combine a land based Aegis Ashore site in Romania with a traditional Aegis system aboard navy ships to provide unique missile defense protection on the continent.

These multiple successful launch again demonstrates the accuracy, robustness and technological advances we are incorporating into our missile defense products. These advances will ensure we can provide defense system to customers that can respond to an ever evolving threat. With customers depending on these systems in their times of need, it is an honor and responsibility to provide affordable and proven systems for our nation and alliance.

The next area I want to highlight is the continued expansion of our international business portfolio. This quarter we secured new awards and made deliveries to new customers as we extended our international presence.

New awards were received across multiple business areas and consisted of aeronautics receipt, I mean, award for 18 additional F-16 aircraft for Iraq. This award now extends the F-16 production line in Fort Worth, Texas well into 2017.

Mission systems and training secured new award for Japan to upgrade Aegis Multi-Mission Signal Processor and other equipment on their Ballistic Missile Defense Ship. Missiles and Fire Control received multiple international awards and clearly had order from Saudi Arabia to provide longbow fire control radars for attacked helicopters, an order from Finland to provide integration support of our JASSM Missile into Finnish Fighter Aircraft, an award to provide Patriot Missile Defense Equipment to Kuwait.

International deliveries in the quarter consisted of delivery of the first C130J Super Hercules aircraft to both the Republic of Tunisia and to Israel. The delivery to Tunisia marks the first to an African country, an entry into a new customer set. Tunisia becomes the 15th country to select the proven, low risk and affordable C130J for its air fleet requirement. Expansion of international sales remains a key component of our corporate strategy. And we're on a path to grow international content from approximately 17 total sales last year to at least 20% in the next few years.

Finally turning to the F-35 program, multiple key accomplishments were achieved in the quarter. And you can feel the momentum accelerating throughout the program. Last month I attended the F-35 CEO roundtable in Fort Worth, chaired by Frank Kendall, the Under Secretary of Defense for Acquisition and Logistics and the programs status briefing by Lieutenant General Bogdan, the F-35 Program Executive Officer. Attendees included Representatives from all nine-partner nations and our teammates on the F-35 industry team.

The meeting reaffirmed just how much progress the F-35 team has made. The customer expressed a renewed confidence in the future of the program and there is a strong sense of partnership across the whole team. We know a lot of work still must be done and at the same time, it’s clear that the tremendous efforts of the team are paying off.

One of the key accomplishments this quarter was the declaration by the Department of Defense of initial operating capability dates for all three F-35 variants, 2015 for the Stovall aircraft, 2016 for the CTOL aircraft and either late 2018 or early 2019 for the CD aircraft for the U.S. Navy. These dates reflect the confidence the customer has in the Lightning 2 and in our team. Our job is to execute on the program, to make sure we meet these critical dates for our customers and deliver the capabilities of this aircraft to our warfighters and allies.

Beyond the establishment of IOC dates, the program achieved a number of key milestones in the second quarter including the delivery of the first F-35C carrier variant to the U.S. Navy. This delivery was important as all three variants are now at Elgin Air Force Base, Florida, where they're training pilots and maintenance personnel for this next generation fighter; completion of high angle of attack testing by the F-35A which is a key measure of aircraft maneuverability; completion of the first vertical take-off by an F-35B Stovall aircraft and the successful first in-flight missile launch by the F-35A variant. Production activities continue to ramp up with delivery of 12 aircraft in the quarter. And we remain solidly on track to deliver at least 36 aircraft this year. The program tempo is accelerating and we currently have our 100 aircraft in final assembly.

In the area of customer relationships and contractual events, we were pleased with the Australia's reconfirmation of its plans to procure 100 CTOL joint strike fighters for its national defense. We look forward to reviving these revolutionary aircraft to one of our key strategic partnering countries. As we continued to work to bring down the cost of the aircraft, we were pleased with reduction in acquisition and operating and support costs reflected in the 2012 Selected Acquisition Report issued by the DoD in June. This was the first year the cost reduction was noted since program inception and we will work with the F-35 Joint Program Office to implement further cost savings measures to secure additional decreases in the total program cost. The top priority of the government and the contractor team is to continue to cost effectively build and deliver the F-35's unprecedented fifth generation capabilities to the warfighter.

I'll now ask Bruce to go through some of the details of our financial performance and then we'll open it up the line for questions.

Bruce Tanner

Thanks, Marillyn. Good morning everyone. My comments will refer to the web charts that we included in our earnings release today if you would like to follow along. Let's start with Chart 3, an overview of the quarter. Sales in the quarter were $11.4 billion, 4% below our results from a year ago, but higher than our first quarter results and as with the first quarter were above our expectations. Segment operating margin was as record 13.4%, a 110 basis points improvement over the second quarter last year. Our earnings per share were also up significantly to $2.64, an 11% increase over last year's results.

We generated $623 million in cash from operations well above the outlook I provided in the first quarter. We returned over $800 million of cash to our shareholders including the repurchase of 4.5 million shares for $465 million.

And as a result of our performance, we're increasing our outlook for operating profit, EPS and cash from operations. So we're very pleased with our results for the first half of the year.

Chart four shows our sales in the second quarter this year versus last year. Aeronautic sales equaled our results last year as lower quantities of F-16, F-22 and C-130 aircraft were offset by higher volume on F-35 production contracts and C-5 deliveries. IS&GS sales were lower due to reduced volume primarily in our intelligence line of business.

Missiles and Fire Control continued their strong performance with an 11% increase from sales coming primarily from air and missile defense programs. Mission Systems and Training sales were down 12% due primarily to the end of deliveries of the PTDS program last year. And finally, space systems was 13% lower than last year due primarily to the delivery of two commercial satellites from the second quarter of last year and none this year.

Moving to chart five in our segment operating results, despite our sales being down 4%, operating profit was up 4% driven by the significant improvement in operating margin of 13.4%. At the end of this quarter, we had strong program execution across all of our business areas that we'll show in the next chart.

Chart six shows our segment operating margins by business area. Three of our five business areas increased operating margin compared to the second quarter of last year with MST having the largest increase due to the settlement of certain contractual matters and better performance in our training and logistics business.

Missiles and Fire Control continue to have excellent results and the increase this quarter was due to improved performance in air and missile defense programs, tactical missile programs and fire control programs. Space system's margin improved primarily due to the increased equity earnings from United Launch Alliance, reflecting the mix of launch related activities in the quarter compared with last year.

IS&GS' margin was flat relative to last year's second quarter results and aeronautic's margin was down this quarter due to the absence of a favorable contractual resolution on the F-22 program which occurred in the second quarter of 2012. Adjusting for the contractual resolution, aeronautic's margin were similar to last year.

Moving onto chart seven. Our EPS grew 11% over the results from the second quarter of last year to $2.64 per share due primarily to improved operational performance. And on our pension adjusted basis, our EPS was $2.87 per share.

We'll turn to chart eight. We'll discuss our cash returned to shareholders in the quarter. We returned over $800 million to shareholders in the quarter with share repurchases in excess of dividends paid. Compared with the second quarter of last year, we repurchased more than double the amount of shares. With the increase in our stock price in the quarter, we saw higher level of option exercise and accordingly, we repurchased additional stock to mitigate share count dilution.

On chart nine, we'll look at cash return to shareholders on a year-to-date basis. We had a strong year-to-date cash -- we had strong year-to-date cash from operations of $2.7 billion and free cash flow of over $2.4 billion.

Through the first half, we returned almost $1.7 billion or nearly 70% of our free cash flow to shareholders. And our share repurchases of over $900 million will exceed the level of dividends paid thus far in the year and greatly exceed to roughly $700 million have seen in our full-year guidance at the start of the year.

Moving onto chart 10, we will discuss our updated view of guidance for the year. As was the case last quarter, we saw minimal impact to our sales in the second quarter as a result of sequestration actions and we are maintaining the sales guidance provided last quarter.

On the other hand, we are increasing our outlook for segment operating profit by $225 million to recognize the strong performance to the first half of the year. As a result of the increase in our segment operating profit, we are also increasing our outlook for earnings per share by $0.40 to a new level of $9.20 to $9.50 per share and also reflecting strong performance thus far. We are increasing our cash from operations guidance by $200 billion to a new level of greater than or equal to $4.2 billion.

Chart eleven shows our updated segment operating profit outlook by business area. We're increasing our outlook in four to five business areas. MFT's outlook is now $75 million higher, Missiles and Fire Control's is now $70 million higher and both Aeronautics and Space are $40 million higher than our guidance last quarter. And turning to chart twelve I'll summarize by noting that we're very pleased with the results for the first six months of the year and they reflect our program execution, the strength of our portfolio and the focus of our work force during these dynamic times.

With that, we're ready for your questions, Sahid.

Question-and-Answer Session

Operator

Thank you. (Operator Instructions) And in the interest of time, we're limiting each to one question. Please return to the queue for any follow up questions. Our first question comes from Carter Copeland from Barclays.

Carter Copeland - Barclays

Hi, good morning. Just a quick question on the order outlook, obviously the book-to-bill was about 0.8 by my calculation and it looks like obviously you have a plan to have a pretty big step up there in Q3 and Q4 to hit the levels you talked about on the previous call. You said you haven't really still seen any impact from sequester, but I wondered if you could give us an update on your expectations for orders and if anything's changed and for last quarter and how about that will shape up for what you're thinking about 2014? Thanks.

Bruce Tanner

Yeah, thanks Carter. So I'll start up by saying, actually we're slightly ahead of where we probably would be at this point of second quarter. I tried to key that up. I think either the first quarter or the top end of the year last year. But we're actually tracking that of expected or slightly ahead of plan. There's up several items and I ask, probably just kind of run down the list by business area, just give you an idea of what we're expecting to happen over the next few quarters.

So the second biggest item obviously is the closure of the last six and seven negations for F-35 and when that happens Carter, I mean think of the increase in orders as being somewhere in the $4.5 to $5 billion amount for just that one closure of contract negotiations if you will. And we're expecting that to happen in the third quarter. Aren't we making good progress that, Marillyn can fill-in some of the details for you if you'd like at a later point in the call?

We also have a number of competitive orders. We're watching an MST in the third quarter including Space Fence and the Air and Missile Defense Radar Program AMDR. We also have an Aegis order for the basic Aegis program, collectively those are about a billion dollars again that we're expecting in the third quarter. Missiles and Fire Control has both domestic and an FMS order for the THAAD program that's expected in the third quarter, so I think of this as the annual buy from the army on the domestic side and one of our international customers tagging on for that order. And that's -- I think I said worth about a $1.5 billion in the third quarter. IS&GS is usual, is nothing -- no one program individually significant, but the third quarter is expected to be higher than either the second or the first. And then, Carter, as we look forward I would expect that the fourth quarter as usual will be our highest quarter of the year.

Now just to sort of summarize all that, I think the third quarter -- you should think of us probably being back at a level maybe slightly higher than where we are or where we were in the first quarter and if all comes as I just laid out including some of those competitions, we should end the year pretty close back about at the $80 billion like I've been talking about the past two quarters.

Carter Copeland, Barclays

Thank you.

Operator

Our next question comes from Robert Spingarn from Credit Suisse.

Robert Spingarn - Credit Suisse

Just Bruce or Marillyn and this could go to both of you, but I wanted to just talk about what we learned in the interim between last call and this call from DOD on sequester. I think about $1 billion was taken from 2013 money for F-35 and it appears to cut, I think five aircrafts from the air force and about two from the navy and the marine core with the reminder of the billion being RDT&E. So to what extent if at all does this impact LRIP-6 and probably more likely LRIP-7 negotiations? And how should we think about that those Lot seven aircraft from the 29 aircraft originally funded in '13?

Marillyn Hewson

Thanks for the question Rob. First, I'd say that, our customer really has not come out with a definitive position on how they're going to take into account sequestration. I know there has been lot of speculation. I'm not going to speculate with you on what they'll come out with.

We're working closely with them. They're looking at different scenarios of how they are, if they'll address it. One thing I will say is that they're very supportive of the F-35 and we'll just have to see how it comes out.

We've seen in terms of any impact that we might see on F-35 that we backfill probably by international opportunities because as you can see that's where we're going to ramp up. In fact, we look over the next five years close to 50% of our orders will come from international customers. So we've got to just wait until they come forward with or wait until the Department of

Defense comes forward with what their plans are and then we'll adjust accordingly.

Bruce Tanner

Yeah. Rob, I'd like to just add a little bit to what Marillyn said. I think the negotiations on six and seven were clearly targeted to sort of keep the quantities sort of pre-sequestration. So think of the negotiations that we hope to close fairly quickly here as being the same quantities we have embedded within the fiscal year themselves not adjusted for sequestration.

And I think Secretary Kendall has been pretty vocal in the press about trying to keep quantities and trying to prevent sort of the reopening of contracts. And so we're optimistic if that kind of plays out well for that negotiation that were not impacted to the level that you talked about.

As Marillyn said, we're watching the FY14 budget closely but at least, as we've sort of done comparisons in particular the President's budget, there seems to be more reductions to non-aircrafts elements of the program than aircraft programs, which we think from a sort of a billed rate in bringing the overall cost profile of the program down is the right move from obviously our perspective.

Robert Spingarn - Credit Suisse

So, Bruce, if I want to understand what you both just said, it's not so much about quantities, it's more about total dollars and these dollars don't necessarily come off of unit price but from other areas of the program?

Bruce Tanner

Yeah. I think you said it just right, Rob. In fact, I've said in a media that this morning and I think I've said in my prepared remarks that we've seen less impact from sequestration sort of red large than we expected to through this part of the year. I'll say frankly from our perspective, I can't speak obviously for all of the industry, but I think the Pentagon Secretary, all the way, up and down to Pentagon has been very prudent in the way that they've managed the sequestration impacts and I think they've done a very nice job doing that from an industry's perspective.

Operator

Thank you. Our next question comes from Jason Gursky from Citigroup.

Jason Gursky - Citigroup

Good morning, everyone. Bruce …

Marillyn Hewson

Good morning.

Bruce Tanner

Hi, Jason.

Jason Gursky - Citigroup

Bruce, this question is for you, in the slide deck you've got a line in there on chart nine that says you are on track to exceed full year cash return commitments. You've done that on the repurchases the $926 million versus the $700 million, but keeping in mind that the goal here was to keep the share count roughly by an offset dilution? So can you just provide a little bit more update on what exactly you mean by on track to exceed for your expectations, is that around the share count itself or is that a comment more around the $900 million versus the $700 million?

Bruce Tanner

Yeah. Probably neither actually, Jason, it is more of our long standing goal is to give 50% of more free cash flow. I'll say we pretty much get there, obviously we just did and so, in fact I was saying, did $700 million plus the dividends for the year. So we've exceeded that already on a year-to-date basis.

And I think probably embedded your question is so what is the outlook looks like for the rest of the year and how does that expect to play out. I've got to believe with the stock sitting where it is today in the level of options that have been exercised to date that those will continue if the stock stays where it is today. It's actually up a couple dollars at least last I looked at it today, which will probably continue that trend and just to give you some perspective there, we've had 4 million, we had 4 million options exercised in the second quarter of 2013 compared to just over 1 million in the second quarter of 2012.

So, you know if that trend continues that will be obviously the motivation for us to continue to share repurchases at the level we've had in the past but that will be dependent upon us watching that option exercise and its effect of the dilution of the share count.

Operator

Thank you. Our next question comes from Robert Stallard with RBC Capital Markets.

Robert Stallard - RBC Capital Markets

Thanks so much. Good morning.

Marillyn Hewson

Good morning.

Bruce Tanner

Good morning, Rob.

Robert Stallard - RBC Capital Markets

(Inaudible) a follow-up of Jason's question. If you're obliged to carry on buy back stock at this sort of rate, does this jeopardize or impact on your first ability to increase the dividend debt force?

Bruce Tanner

Well, I guess you can't do that to infinity without impacting the ability to pay dividends back, Rob, but honestly I don't think, you know, if you look at our track record, in terms of what we've done with dividend increases and you know, I think that's probably always the best indicator of what we'll do in the future. The one thing that's kind of interesting about where we sit from the amount of options that are still outstanding and have yet to be exercised, I want to say there is about $15 million, 15 million, excuse me, shares of options that are outstanding, about 12.5 or so are vested and the other, the remainder unvested. But we've kind of weeded out, if you will, sort of the low dollar option amounts. So the options that are being exercised today come with, you know, option prices at the $80 plus per share for the most part.

So you know think of the incremental difference between sort of buying back the shares to offset the dilution and the price of the options that are being exercised is maybe less than they would have been years ago when we had some options at the $35 to $45 levels. So that's something to mitigate. What you might think of in terms of the overall level of cash sort of required to continue to share repurchases. At this point I think we've got the flexibility to do that. we're still looking at, you know, with the guidance we've provided this year, $4.2 billion, our overall capital, you know, somewhere in the billion dollars, maybe a little less. So free cash flow of $3.2 billion we started out, I think we've got what, $2.8 billion on the balance sheet as we ended the quarter.

So, you know, I still think we've got the fire power to continue to do that going forward in part because of the reasons I've just said with the benefits coming from those options when they are exercised.

Operator

Thank you. Our next question comes from the line of Noah Poponak from Goldman Sachs.

Noah Poponak - Goldman Sachs

Hi. Good morning everybody.

Bruce Tanner

Good morning.

Bruce Tanner

Hey, [Tom].

Noah Poponak - Goldman Sachs

If I move to the low end of the revenue guidance range which you've indicated would happened under sequestration for 2013, the back half of the year would experience something like an 8% organic revenue decline. In that, what is your assumption for the growth rate of U.S. DoD versus U.S. non-DoD versus international? And then to extend you're willing or able to, you know, can you talk about how much different we should assume those would be in 2014, if at all?

Bruce Tanner

Help me with the last part of your question, Noah, if you would. Please tell me more about what you're looking for, the comparison of '14 to '13, what was that?

Noah Poponak - Goldman Sachs

Yes. Basically what I'm saying is you know is there any reason why we should not take those growth rates you've assumed in the back half of '13 and carry them forward into '14 in the center or sequestration as [stepping].

Bruce Tanner

Yes. So I think the first part of your question was if we could kind of squeeze for the back half of the year, it looks like we're down, I think you said 8%. I think that's about right. Noah, I don't have it off the top of my head. I will say that if we, as I said, to answer a previous question, as we look at the overall year and where we sit to the first half of the year, our sales were ahead of expectations in the first quarter. Our sales were ahead of expectations in the second quarter albeit not as much as they were in the first quarter. So we are tracking better than expected for the first half.

The $825 million that we kind of came up with point towards the low end of the guidance was sort of -- as we used in the past sort of a parametric or a mathematically derived number that frankly we haven't seen materialize as quickly or as much as we thought when we did that calculations.

So, I'm hopeful that we actually -- our culture towards the -- maybe little bit higher than the low end of the guidance, as we said earlier -- as I said earlier we've got one quarter to kind of squeeze out the fiscal year '13 impact for sequestration. It seems like a lot has to happen that quarter for that sort of mathematical modeling to come into fruition.

As far as the build rates going into 2014, I think, we're very similar to the situation that we were going into fiscal year 2013 in the -- we haven't seen truly the impacts in '13 than we had expected in large part because again I think the DoD in the Pentagon has done a fairly masterful job kind of deflecting some of that. It's some of the expensive of operations and maintenance and some readiness issues, which are not good by any means, but in terms of the industry's perspective I think it's been helpful.

And so, we are kind of going to go into '14 somewhat the way we went into 2013 and there I think the -- we are going to have a similar story as I said at the start of the year where our long cycle businesses will not see much impact even if the '14 budget is set by sequestration. And our short cycle businesses will have that impact. But I got to believe the ability to continue to differ and push the sequestration impacts on O&M, readiness and the like will be mitigated by '14. So I think '14 versus '13 will be similar to what we expected to kind of happen as we enter the year '13 if that makes sense.

Operator

Thank you. And our next question comes from Rich Safran from Buckingham Research.

Rich Safran - Buckingham Research

Good morning.

Marillyn Hewson

Good morning.

Bruce Tanner

Good morning.

Rich Safran - Buckingham Research

This question is either for Marillyn or Bruce. Marillyn on your comments regarding at on second tranche of the F-16 and extending the backlog to ’17. Now, I want to know if you could comment on other opportunities for the F-16 and maybe also if you could make the comment here about what you are thinking about in terms of production rates? And as long as on maybe legacy programs here, maybe you could also comment on the opportunities and the outlook for the 130J in production rates?

Marillyn Hewson

Sure, thanks for the question. So, on opportunities for F-16 as I did say with the Iraq sale that gets us out into 2017. But we also have opportunities and import for the UAE. Potentially, there are other Middle East countries. We have opportunities in South America. So, our production rate today is about 13 aircrafts per year. And it should continue on out through at least to ‘17 timeframe. And then as we see additional orders come on line, we would continue to stay on whatever rate that would lend itself to.

We also have F-16 upgrade work that we are doing today which is good work for us as we, with the time line upgrade of F-16. On the C-130J, our plan this year is to deliver 24 aircrafts and we’ll continue on that rate. We have a lot of international demand for this C-130J. And we are hopeful on moving through the multi-year opportunity with the U.S. government which would be up to 83 aircraft through those opportunities in Saudi Arabia, opportunities in India. So we have the C-130J also has good opportunities.

Operator

Thank you. Our next question comes from Joe Nadol from JP Morgan.

Joe Nadol - JP Morgan

Thanks. Very nice margins. I have actually just two quick ones. One is, Bruce, you talked earlier about the backlog in what you expect to happen by the end of the year, about $80 billion. Funded backlog, does that look at a similar profile that they were due at 55. Do -- I think at the end of last year, do you expect that to be roughly the same?

And then the second question is just on the F-35 SDD. You took another reduction, profit rate reduction in the quarter. Could you just give some color on how you think that tease you up going forward on that contract, what has to happen to make that the last write down? Thanks.

Bruce Tanner

Thanks Joe. I'll try to take both those on. The backlog, as you said and we're looking for a total backlog of $80 billion or so by the end of the year. I think we are around $55 billion or so of funded backlog. I wouldn't think -- I think I would think that relationship will sort of hold pretty steady, would be my guess. Maybe a little bit higher, like think about it because I would think we'd get full funding for a good portion of that lot [6 and 7] negotiation, so that on a percentage basis, it might actually be a little higher than it is today. And as far as the SDD, you're right. We did take a [D-book] this year, essentially similar to the one we took a year ago at this timeframe.

The way I would describe that Joe, is in the quarter, we finalized an agreement with the government which we've been working for quite some time for the plan for earning the remaining fee on SDD and you should think of that as being both for the remaining developmental milestones on the contract as low as sort of an overall measure of performance that's an incentive based measurement that will take place at the end of the contract. And I'll just say that both criteria, the developmental milestone, they're linked to specific dates and accomplishments through the remainder of the SDD period. And even more so I'll say the sort of overall performance measures at the end of the contract which you should think of as being tied to both schedule performance and cost performance between now and the end of the contract.

Both of those, I would characterize as very tough criteria for us. So this is our best estimate of how we're going to perform against that criteria. I'd like to say that this is -- obviously I think this is our best estimate of how we'd perform against that criteria and it is a little tough maybe than what we were thinking it was when we set the numbers a year ago just on …

Operator

Thank you. Our next question comes from Bill Loomis from Stifel.

William R. Loomis - Stifel

Thank you. Just staying on F-35; Bruce, you talked about the productions, the quantities are still undecided. But just from a revenue standpoint of the work you're doing, is it still running about 15%, can we expect that to continue? And then just another questions on IS&GS with the backlog showing sequential decline and you've got two big wins last year with GSM and [Pulver] and we're still declining. When do you think we might see some stability in IS&GS? Thanks.

Bruce Tanner

Hey, Bill. I'll answer those. So we are about 15% of total revenue for the F-35 program. I think that number continues to increase over the next few years. I think we were somewhere in the 13-ish or so range. I've lost track where we were last year. So we had about a 2% increase if memory serves me right in the percentage of total F-35 compared to our total sales. That number again, I think increases going forward and then how much I would say, maybe not as much as the 13% to 15%, but still increasing between 2013 and 2014.

IS&GS, the sequential decline again, kind of as expected and the reversal I think that you talked about Bill, this is still a business that's very much sort of orders similar to or excuse me, backlogs similar to the sales level. For us to get there, we would expect to have a greater fourth quarter which is the historical trend for IS&GS. And what I would expect to have happened is that we'll see from an orders perspective, higher orders in both the third quarter than we saw in the first two and the fourth quarter will be higher still than the third quarter.

Operator

Thank you. Our next question comes from Peter Arment from Sterne Agee.

Peter Arment - Sterne Agee

Good morning, Marillyn and Bruce.

Marillyn Hewson

Good morning.

Peter Arment - Sterne Agee

Bruce, maybe this question is for you or maybe Marillyn can take it. Just in general headcount levels, you guys have been out front on reducing your overall cost base quite a bit over the last couple of years and according to my calculation looks like headcount has come down by about 8% during that period. I mean, you are still seeing a lot of opportunities for that whether it's early retirement programs or productivity, or just in general mandated by the overall budgets? Thanks.

Marillyn Hewson

Okay. We have taken net cap down from about 146,000 employees about two or three years ago to 116,000 now, so you are right, headcount has been coming down. We've taken some direct activities where we took out a number of management back when we do our voluntary separation program at that time. We will continue to adjust our business to what's happening and our business base.

So that's what you are seeing is just the budget environment and adjusting to contractual delays or reductions that come with that. So those are the types of actions we'll take and what we don't know is what sequestration will bring. Certainly, if we have a significant impact on program from sequestration we'll see additional reductions to that. So we basically saw the business to the environment that we are operating in.

We are also coming out of footprint. We've done a lot and you've probably seen we reduced our capacity both shutting down facilities, as well as moving out lease space into our own space and that's something that we've done for past several years. But it's just of course we take to managing our business to make sure that we get our infrastructure and our labor force aligned with business base that we have.

Operator

Thank you. And our next question comes from Myles Walton from Deutsche Bank**.**

Myles Walton - Deutsche Bank

Quick one and then one on pension, well, the quick one is the EACs revisions not related to revenue for the year, it looks like coming roughly flat year-on-year is that currently what's built into the guidance?

And then one on pension, Bruce, if you can kind of give us little color, obviously the rates moving higher here, it's going to help you pretty significantly if you stick around. I think on a sensitivity basis like as a potentially $300 million, $400 million help for you for next year versus what you previously told us. As well, can you comment on that if that changing your attitude towards cash contributions, the remaining $750 million, still have as discretionary for the rest of the year? Thanks.

Bruce Tanner

Thanks, Myles. So EAC revisions, I think, as usual Myles your math is right, we're kind of spot on maybe a slightly different little bit down from the first half of this year compared to the first half of the last year in terms of our overall EAC revisions.

Looking forward for the rest of this year, the second half, at least in the plan we kind of expected the level that will be similar to a little bit higher than where we were last year and that could obviously change as sort of risk retirements happen quicker than we plan them obviously.

But as we sit here today, overall, we would expect still be, I think last year we were about 34% overall our EAC revisions versus our total earnings, so we're going to be right at ballpark, maybe a little higher at 35-ish or just 36% is kind of what I would expect to see.

So on pension you asked about the discount rates or the interest rate changes and so forth and I'll just -- I'll give you a little bit of perspective, obviously we won't set this until the end of the year. But clearly there have been changes to rates in the first half of the year that want some discussion.

So interest rates so far are up, probably about 75 basis points, and our asset returns are also slightly positive as we sit here this year. But as you know, our pension adjustments that we're talking about much more sensitive to changes in the interest rates than changes in our asset return.

So you did some calculations just remind everyone else on the call. I think the sensitivity that we provided in previous 10-Q and 10-K filings are still appropriate. So for discount rates every 25 basis points change is worth about a $145 million change in our FAS expense, whereas for asset returns it takes a 400 basis points change to be about an $18 million change in our FAS expense.

So, overall, if we were to set the market today, we would expect to have a positive adjustment to fast cash again if those results held. I would remind that between now and the end of the year we typically do sort of accrual settings that look at the current population of employees to see what has changed and that population as we do reductions in force, you know some of the dynamics of that accrual study do actually change in terms of the acquisition of the workforce that, upon which that liability is built upon.

One of the bigger changes that and it may not happen between now and the end of the year, but we're watching it closely as we are expecting a new sort of standard mortality rate to come out which I guess from a good news perspective, since all of us are going to live longer, sort of from the bad news perspective, it says your liabilities are likely going to be increasing per pension because people are living longer. So that will have a bit of a mitigating effect on what we just described there in the numbers that she said but again we'll set that up. We'll try to give you the same sort of preview, if you will, in the third quarter call that we do typically every single year. And that's when I'll give you probably a little more detail into that.

As far as cash contributions, we've actually already made in the third quarter the second tranche of the $750 million for a total of $1-1/2 billion pension contribution. So, that is done for the year and we'll, you know, as usual, we always evaluate whether or not the need arises to do anymore towards the end of the year when we sort of see our cash from operations flung out on a four year basis. We'll try and give you some insights into that, Miles, again when we talk again in the third quarter.

Operator

Thank you. Our next question comes from Howard Rubel of Jefferies.

Howard Rubel - Jefferies

Thank you very much. I think this is kind of a two-part question, half for Bruce and half for Marillyn. If we look at the outlook for you, Bruce, and we kind of split the revenue forecast and look at what you've done for segment profit increase, it would appear as if margins are going to be down almost a couple of hundred basis points in the second half versus the first half. It looks like most of the increase in the outlook was attributable to the pick up. So maybe Marillyn, you might be able to address some of the productivity incentives underway that, you know, have enabled you first to do as well as you have in the first half and then maybe also address why it wouldn't stay at the same rate, other than that one large contract adjustment.

Bruce Tanner

Howard, let me try to address. You asked a pretty specific question there on segment operating margins in the second half and what's expected to happen. So we did have a couple of things happen the first half of the year, including as you saw within our MST business, a couple of contractual resolutions. They were a good size. I mean obviously if you look at the margins for that business, in particular, that's a record level of margins and it was obviously, maybe not obviously, but it was driven by those contractual resolutions. Those are not expected to replicate in the second half of the year. So that's one item that will bring it down first half relative to second half.

Secondly, space systems also up a little bit first half of the year. Think of that as some of the phasing and the mix of where we're seeing some of the URLA equity earnings and expect to see a little bit of a reduction in that in the second half of the year. You know so that's, I think you did the math exactly right in the guidance we have, Howard. You know the wild card in all this is we have a certain level of planned, I'll say, risked retirements that we expect to occur in both third quarter and fourth quarter. And just as we had some benefits beyond what we were planning in the first and second quarter, if those occur as they did in the first and second, that may be able to mitigate some of that reduction you see or you're talking about. If they don't, then we won't see that happen. It's kind of that simple. Now I'll put the call back over to Marillyn for I think the second half of your question.

Marillyn Hewson

Your question about, you know, what do we see in terms of continued cost reductions, I would just, you know, point to the fact that we've had, we've been very corrective as I said earlier, the last several years, I'm just getting ahead of the budget cuts by reducing expenses and headcount. But we have very few leaders that don't just manage programs, they manage their business on an ongoing basis. And they have very strong cost control discipline in their business. So we look at that and monitor that on an ongoing basis. As I said earlier, we tried to keep our structure in line with the business base we have.

The other thing that is driving the performance of the businesses is just consistent performance on the programs. We don't -- we're performing well across all of the business areas with very deliberate management of the programs in making sure that we perform and meet the cost targets that those contracts drive and continue to look at ways that we can improve our margins on the programs.

It's -- I think it's a good -- straighter good performance by our leadership and our team across the business in executing on programs that they have.

Operator

Thank you. Our next question comes from Sam Pearlstein from Wells Fargo.

Sam Pearlstein - Wells Fargo

Good morning.

Marillyn Hewson

Good morning.

Sam Pearlstein - Wells Fargo

I wanted to ask something, Bruce, just your discussion about the options just triggered something which is just in terms of the incentive compensation and thinking about things on going forward basis. I know that TSR is an important metric. But if a lot of people start cashing out of options, do you need to do something to continue to incent people on a go-forward basis. This is kind of part one.

And part two, the higher stock price itself. What is that going to do for the remainder of the year in terms of the Rabbi Trusts or any other sorts of, I guess, compensation programs and the shares outstanding as a result?

Bruce Tanner

So Sam, I'll address the first part. So if you have read the proxy, what you've seen happen in the past two years, we've actually been lowering the number of options that are paid not just to the senior leadership team but to leaders -- leadership in general. And in fact, at the start of this year, we eliminated option as a component of our executive compensation program. So all of our equity compensation going forward is either in the form of RSUs or performance stock units.

And so one of the things that I don't think we necessarily had a complete understanding amongst all of our investors is that some of the dilutive aspects that have been occurring -- that have been meeting to be offset through share repurchases had been because of the level of option exercises. So if you track the number of outstanding options over the past few years, that's come down fairly significantly.

And I guess, it's kind of a good news, bad news each. As the stock price increases, we have more option exercise which increases the dilution effect but it also gets rid of those options at a faster cliff such that going forward. I don't have this on top of my head but I want to say on an annual basis, we were currently providing somewhere in the 5-ish -- maybe 6 million shares or so of options on an annual basis, maybe more like 7 million shares.

And if you're just providing the same amount of executive compensation, it takes a lot fewer shares to do that with RSUs and performance stock units. So on an annual run rate, we're going to see less dilutive opportunities, if you will, from our executive compensation program than we've had in years passed. So that's a direct reflection of some of the conversations we've had with investors who raised that point to us and we made that change accordingly.

I think your second question was the higher stock prices -- higher stock price in the second half of the year and its impact on the Rabbi Trust. And really there is not an associated impact there as I think of it, but certainly Rabbi Trust, you can put it in essentially the same sorts of options that 401-k opportunities are for employees. And we try to match that from our liabilities perspective. So I think it's more targeted to overall market performance, if you will, then directly to the Lockheed Martin stock.

Operator

Thank you. And our next question comes from Doug Harned from Sanford Bernstein.

Doug Harned - Sanford Bernstein

Good morning.

Bruce Tanner

Hi.

Doug Harned - Sanford Bernstein

Following on aeronautics, if you look forward and you had about 12% margin levels recently. When you look forward, you are going through a fairly significant mix change with F-35 growing its share of revenues but at the same time, you've got more and more sustainment coming from F-22, F-16, C-130J, how do you see those two things playing out going forward and should we see aeronautics margins tend to stay at the kind of levels they're at today?

Bruce Tanner

Yeah. So I'll try that one. We've said for quite some time, I always sort of describe this as the algebra of this business when it comes to aeronautics margins. Going forward, even though the overall F-35 margins are expected to increase going forward, we have a bit of mitigation impact there because we just lowered, if you will, the go forward booking rate, if you want to think about it that way from SSD contract by virtue of what we did with the adjustment we took this quarter.

So if you kind of throw all those things into the mix, what I would expect to see is that the margins of aeronautics will come down a little bit in the future as we've predicted probably for the last two or three years, simply because of the higher F-35 volume. Even while the F-35 on a standalone basis is kind of increasing year-over-year, it still has a dilutive effect on the overall margins aeronautics because some of -- the volume that it is offsetting was higher margin C-130 and F-16 were.

Just to give you a little bit of perspective -- I think I've been fairly consistent saying, we like to see the F-35 production contract sort of get into a double-digit margin level by the time we get to the 4A production. If we just strip out the SDD performance from the overall F-35 program of this form on the production contract, we should think of this as we're kind of in the higher, single digit levels today. So that program in generally is kind of performing in line with our expectations.

SDD clearly has **--** we don't like to have back to back adjustments like we had in the second quarter of last year in the second quarter of this year. So that has been performing from a margin perspective as well as we'd like it to. And that has a bit of a drag as I said. But I think the production part; they're actually performing pretty well. But that still is what's causing again, what I call sort of the algebra effect on aeronautics margins.

Jerry F. Kircher

I'm sorry. I think you're coming up on, yeah maybe one last call? Someone has questions?

Bruce Tanner

All right.

Operator

And our final question comes from George Shapiro from Shapiro Research.

George Shapiro - Shapiro Research

Hi, good morning.

Marillyn Hewson

Good morning.

George Shapiro - Shapiro Research

Two quick ones probably for you Bruce; following up on that F-35; in the quarter you had commented you had a $50 million increase in profit and revenues were up $175 million. So could you break out how much of that was inception to date pickups versus just maybe, say the margin improvement itself? And then in the space area, you had a $50 million increase in the ULA profit which struck me as a big number. Did you just kind of just go through what caused that and is there any way to forecast what that might be going forward? Thanks.

Bruce Tanner

Yeah. George, I'll try to address both of those. So you're right. I think the press release identifies the amount that you talked about in terms of the $50 million and the $175 million. Maybe the simplest way to think of that George, is sort of go into the mid-single **--** the upper single digit levels on the sales volume and take everything else as soon as that sort of the step up in the quarter. I don't have the number off the top of my head, but it's a pretty good chunk of that overall $50 million on that $175 million sales increase. But I don’t have it sort of exactly in my head.

The $50 million ULA is the (inaudible) one of the reasons and one of things I talked about earlier in terms of a lot of reasons why the margins in space systems are higher. That’s a couple of things again. We mentioned the mix aspects within ULA; ULA margins are **--** the mix result are better this year than last year in terms of profitability in terms of launches and the volume will be up as well. So we would expect to see for the rest of the year, not probably quite a comparable level as the first half. They’re pretty close to that level in the second half.

I think the thing that’s stuck out and the reason it stopped so much the second quarter of this year is because actually last year due to some of officer issues, the mix issues and the phase within the year, last year's second quarter was by far the lowest quarter of the year for ULA from an equity earning's perspective. So that made this quarter, although it is higher than to move, it has been historically, it made the difference between second quarter last year and second quarter this year appears even greater.

Marillyn Hewson

So let me wrap up our call today by again highlighting that I believe our second quarter results and increased guidance illustrate the solid position and performance of the corporation to provide value to our shareholders and solutions to our customers. Even in an uncertain budget environment, our product portfolio, strong balance sheet, robust cash generation and the exceptional execution by our 116,000 employees will continue to propel our corporation forward. So, thank you again for your interest and for joining us on the call today. We look forward to speaking with you on our next earnings call in October. Thanks.