

# Defense Industry Outlook

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November 2018

# U.S. Defense Spending Growing, But....

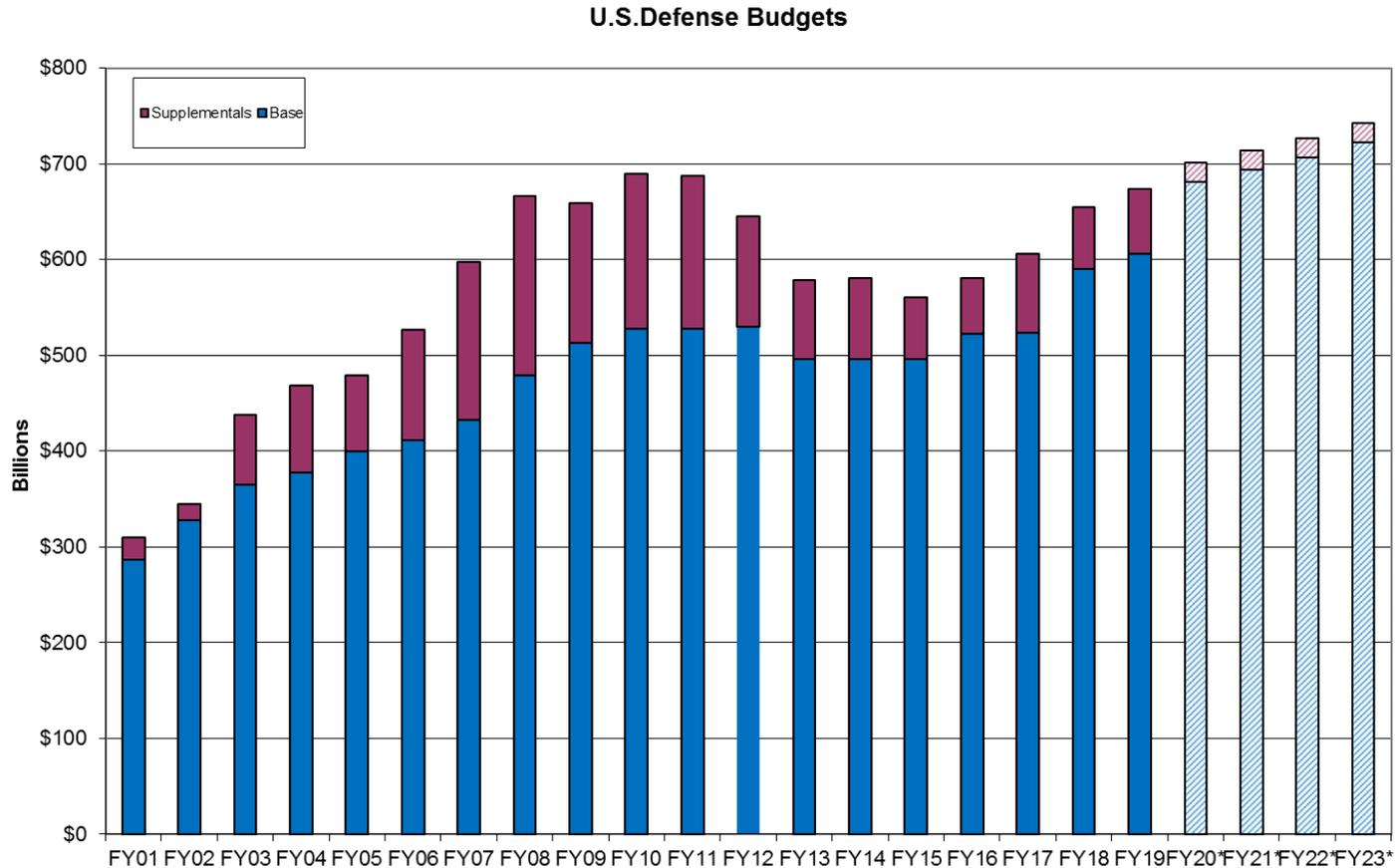
- **Budget agreement sets FY18 & FY19 well above sequestration**
- **Sequestration returns in FY20, but budget grows modestly both in President's request and under sequestration**
- **OCO likely to remain near current levels or higher due to fight against ISIS and to supplement base budget**
- **FY19 budget the first budget in a decade passed before start of fiscal year**

# ...Longer Term Trend Becoming Less Favorable

- **Recent calls for 5% cut to planned FY20 spending**
- **Impact of mid-term elections**
- **Tax reform, other fiscal priorities could limit longer term budget growth**
- **What gets cut?**

# FY19 Up Modestly From FY18

- Following 13% increase in FY18, FY19 base budget up 3% to \$606B



Source: US Dept. of Defense  
 \*requested in FY19 budget

# Spending Priorities Shifting to Dealing with Russia and China

- National Defense Strategy shifts focus from combating terrorists to large scale war with near-peer adversaries (read Russia and China)
- Funding will shift from improving readiness to modernization, benefiting manufacturers of large platforms such as aircraft, ships, and ground combat vehicles
- Significant funding for recapitalizing nuclear forces with new ICBMs, bombers, and missile submarines

# DoD Technology Priorities

- **Hypersonics (both offensive and defensive)**
- **Autonomous systems**
- **Electronic warfare**
- **Space**
- **Artificial intelligence/machine learning/data analytics**
- **Cyber**
- **Directed energy weapons**
- **C4ISR**

# F-35 Largest US Defense Program

- **Price coming down as production increases**
- **International demand key to program profitability**
- **Lockheed rebidding key systems to reduce costs**
  - **Distributed aperture system**
  - **Integrated core processor**
  - **Electronic warfare system?**
- **Reducing prices, improving reliability still sticking points with DoD**

# Key Programs To Watch

- **B-21**

- Award solidifies Northrop's position as major prime contractor and combat aircraft manufacturer
- Classified contract limits information on investment needs and revenue/earnings/cash profile

- **KC-46A**

- More charges for Boeing if it can't meet delivery schedule?

- **Columbia ballistic missile submarine**

- Crowd out funding for other shipbuilding, naval aviation?
- Will require material capex at Huntington Ingalls and GD-Electric Boat

# Few large programs to be awarded

Program (Value)	Boeing	Northrop	Lockheed	GD	Raytheon
T-X Trainer (\$9b)	WON		LOST		
MQ-25 (\$5b)	WON		LOST		
GBSD (>\$85b)	D/S	D/S			
LRSO (\$11b)			D/S		D/S
Columbia SSBN (>\$100b)				WON	
B-21 bomber (>\$100b)	LOST	WON	LOST		

# Hard to Break into US Market

- **More success on components/systems than platforms**
- **Often need to partner with US prime**
- **Domestic operations help**
- **Technology transfer restrictions**
- **Offsets**

# Margin Pressures Still High

- **Procurement changes**
  - Better Buying Power
  - Low price, technically acceptable still around, but less prevalent
  - Fixed price contracts earlier in program lifecycle
  - Fixed price incentive contracts for mature production programs
  - Changes to progress payments?
- **Pricing pressure from primes**
- **Strains on suppliers that also have large exposure to rapidly growing commercial aerospace market**

# M&A Increasing in US

- **Significant consolidation in government services sector due to large decline in demand in recent years, more likely**
- **Growing defense budget, tax cut may prompt more activity in other areas**
- **Recent US deals**
  - **GD bought CSRA**
  - **Northrop bought OrbitalATK**
  - **Perspecta formed from Vencore, Keypoint, DXC government business**
  - **Harris and L3 merging**
  - **SAIC to acquire Engility**
- **International?**

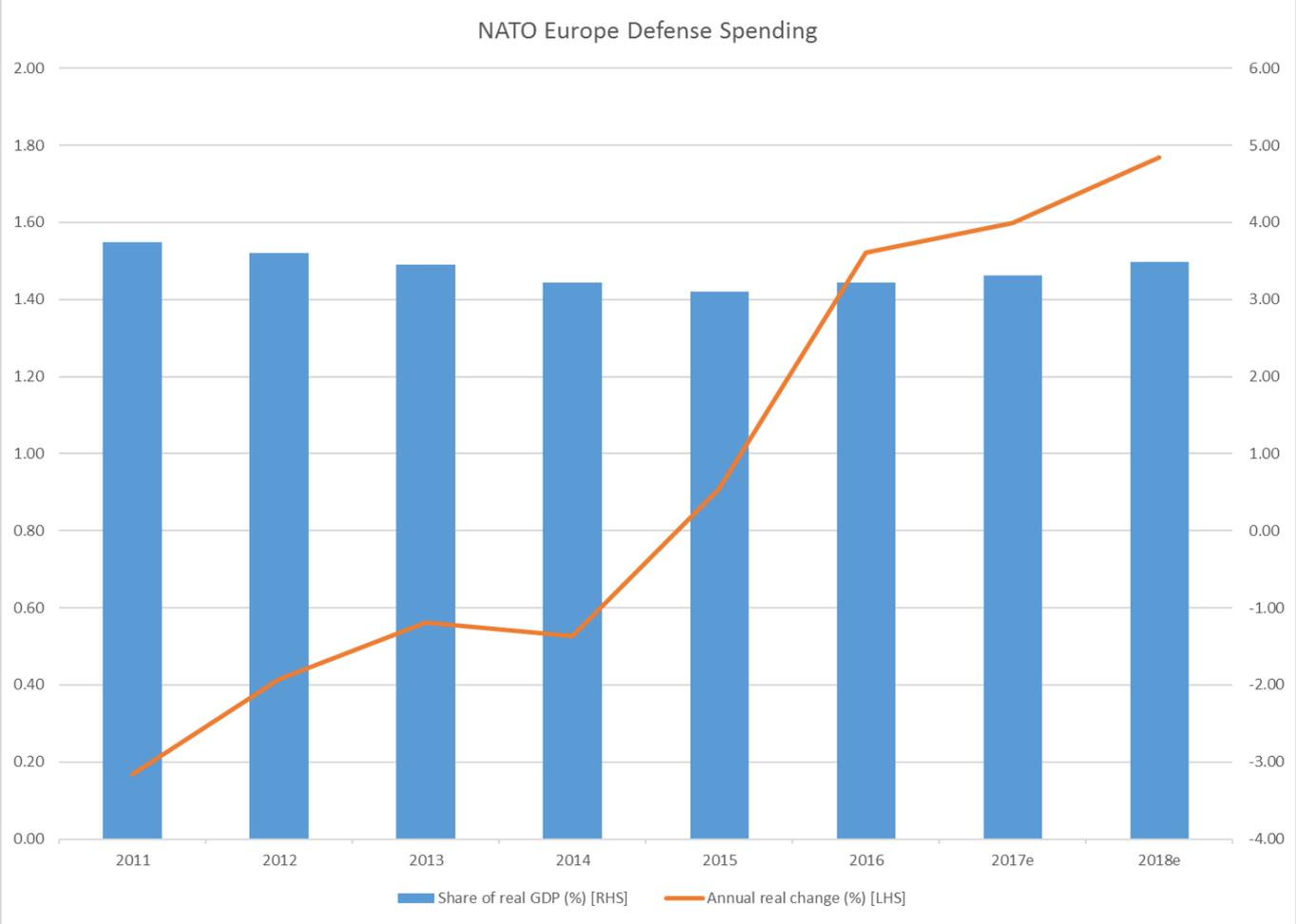
# Threats Drive Global Budgets and Priorities

- **Russia**
- **China**
- **Iran**
- **North Korea**
- **ISIS**
- **Regional conflicts**

# Most International Arms Sales Political

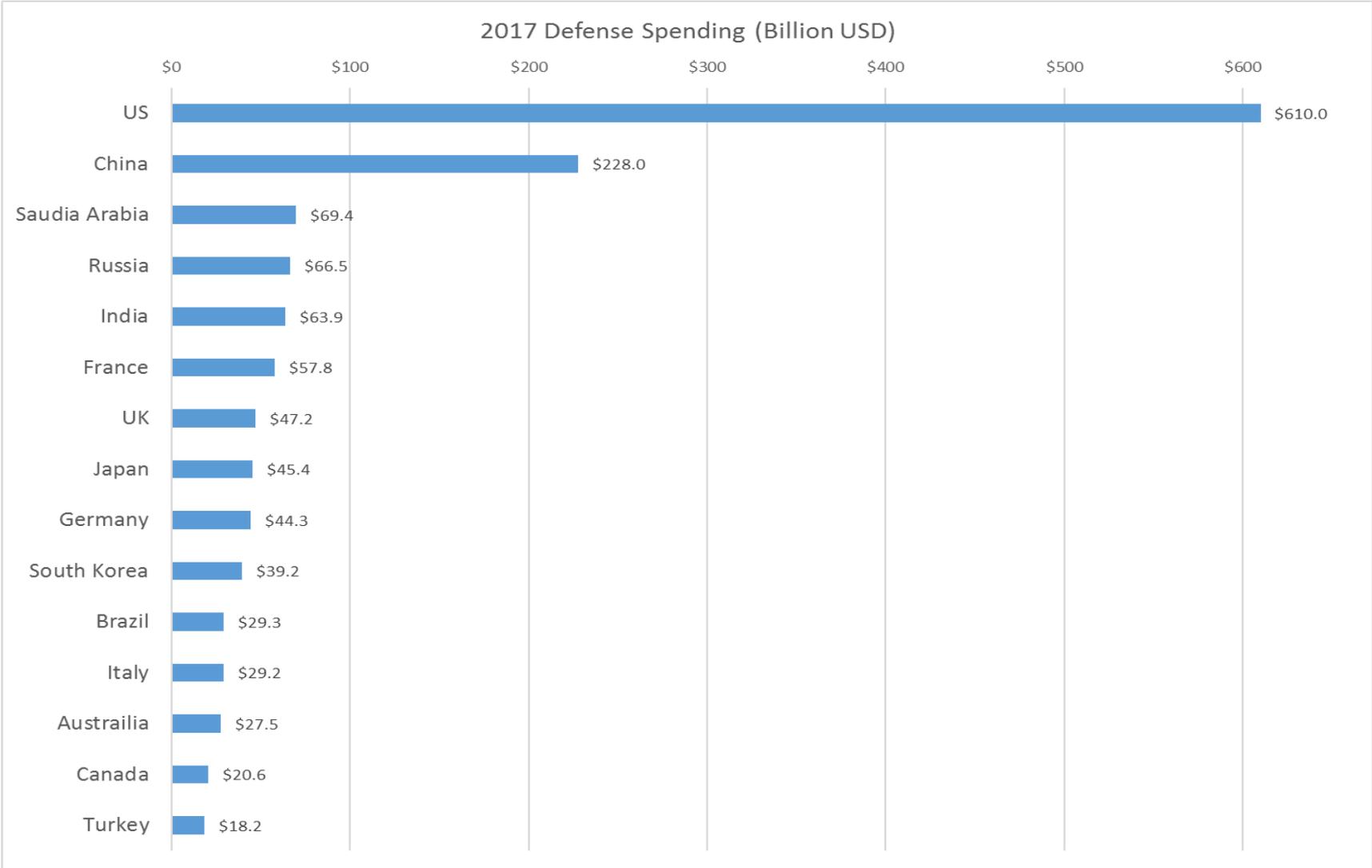
- **Support key allies**
- **Defer enemies**
- **Boost domestic industry**
- **International disputes could impact existing programs, new orders**
  - Saudi ban on Canadian imports could affect \$10b GD wheeled combat vehicle program
  - FY19 authorization bill bans delivery of the 100 F-35s Turkey has ordered
  - Death of Saudi journalist unlikely to stop US weapons sales, but could slow them down, other countries may ban
  - Retaliation to US tariffs

# US Pushing NATO To Spend More



Source: NATO

# Top Global Defense Spenders



Source: SIPRI

# Brexit Could Reshape European Defense Industry

- **Supply chain disruptions**
- **Cross-border skilled labor**
- **Participation on EU-wide programs**
- **Role in European defense strategy**
- **Relocation of facilities**

# Israeli Defense Industry

- **Strengths in high priority military technologies**
  - Air and missile defense
  - Electronic warfare/defense electronics
  - UAVs
  - Vehicle protection
- **Elbit, IAI, and Rafael in Top 50 global defense firms**
- **Partnerships with US firms**
- **Exports to US**
- **US military aid**

# Credit Quality Stable Overall

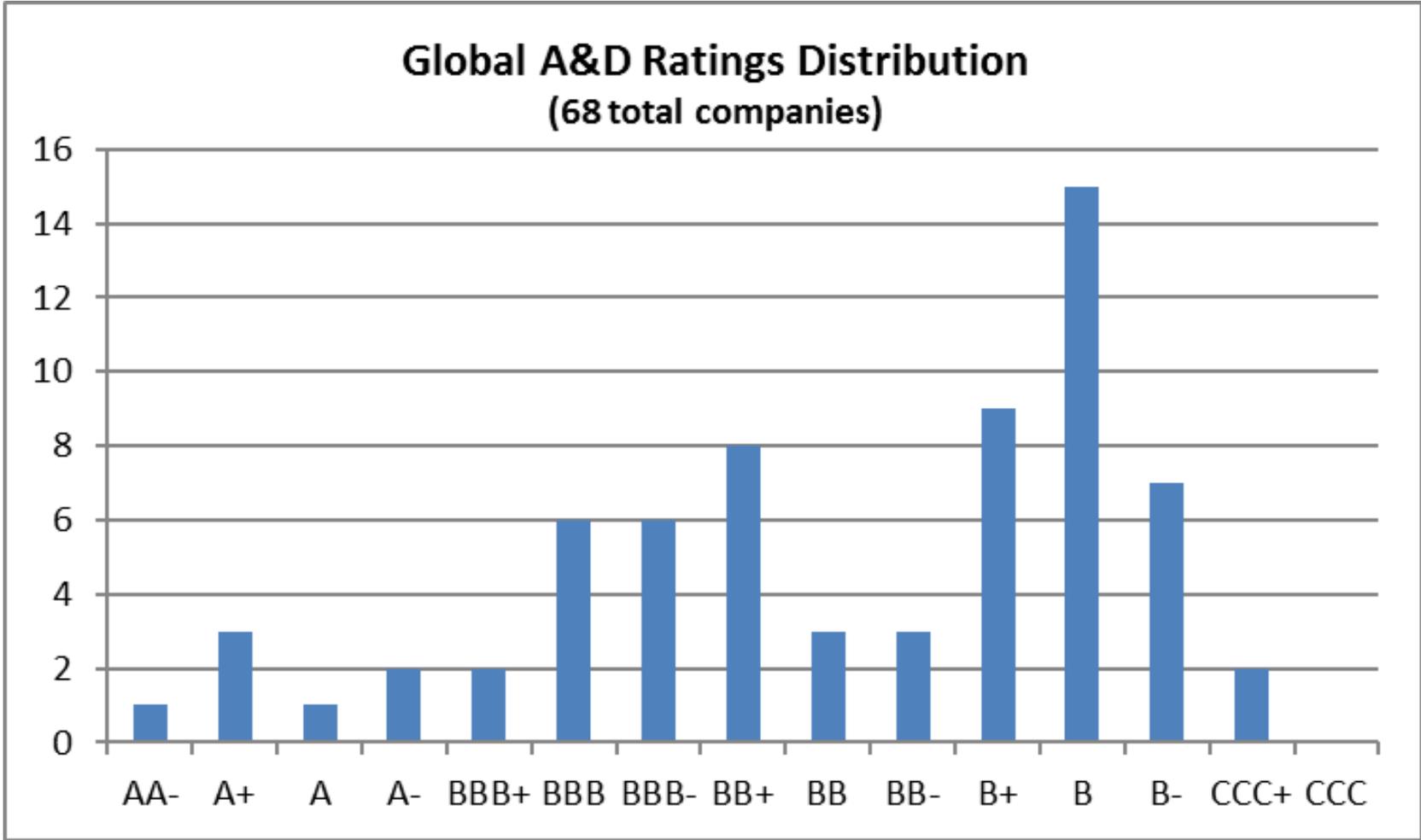
- **Most firms likely to see revenue growth in 2018**
- **Impact of further budget increases could take a while to show up in revenues and earnings**
- **Credit quality of large defense contractors determined primarily by financial policy as cash flows remained strong even with earnings declines**
  - **Could better outlook for defense spending lead to less shareholder rewards?**
- **Smaller contractors and government service/IT still feeling impact of cuts, but should improve with higher spending**
- **M&A impact on credit quality mixed**

# Appendix

# A&D Rating Outlook and Distribution

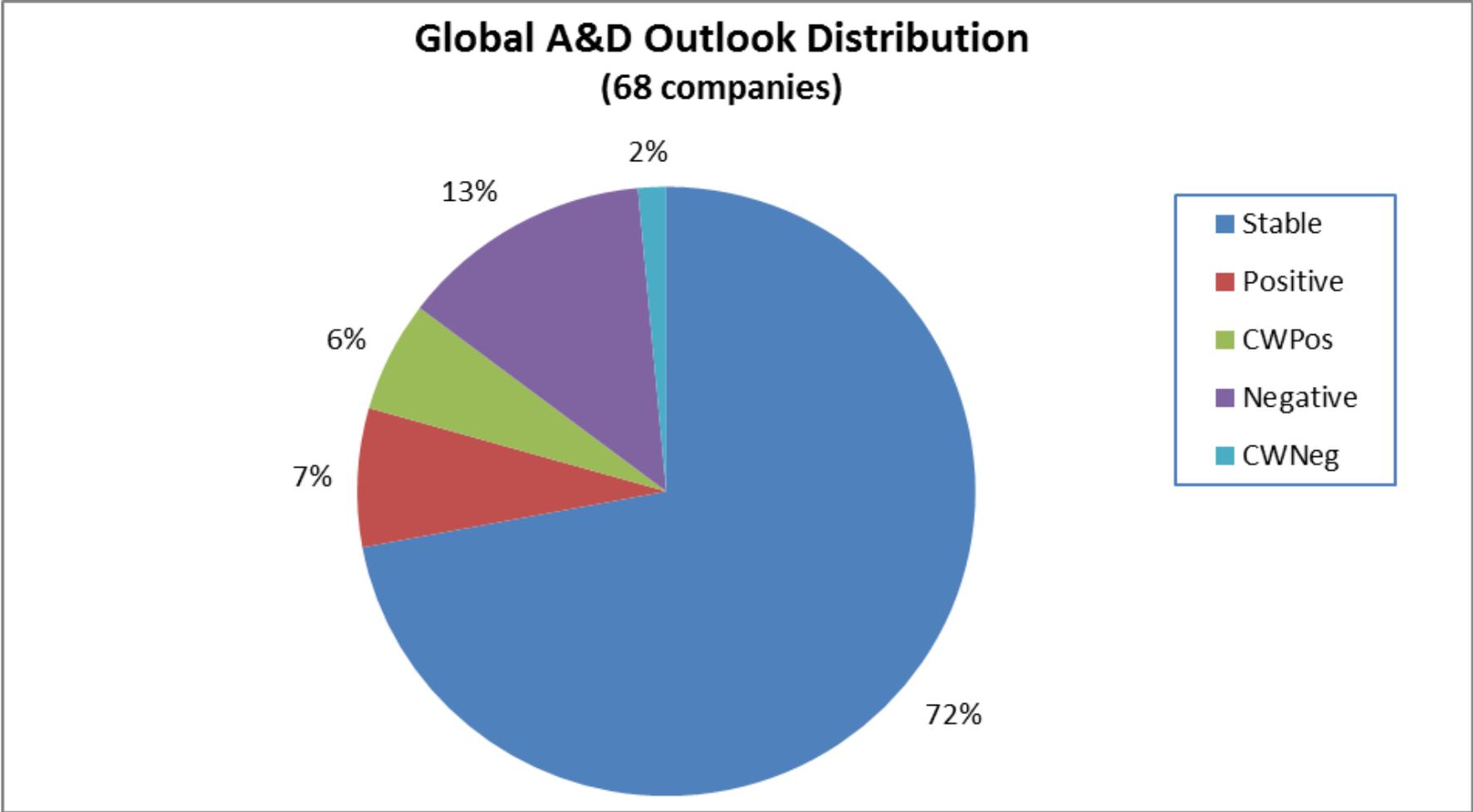
# Rating Distribution

Nov. 1, 2018



# Outlook Distribution

Nov. 1, 2018



# Rated U.S. A&D Companies

Nov. 1, 2018

	Business Risk	Financial Risk	Rating/Outlook
Precision Castparts Corp.	Strong	Modest	AA-/Stable/NR
General Dynamics Corp.	Strong	Modest	A+/Negative/A-1
Raytheon Co.	Strong	Minimal	A+/Stable/A-1
Boeing Co.	Strong	Modest	A/Stable/A-1
Lockheed Martin Corp.	Strong	Intermediate	BBB+/Positive/A-2
Rockwell Collins Inc.	Strong	Significant	BBB/CWPos/A-2
Northrop Grumman Corp.	Strong	Significant	BBB/Stable/A-2
Hexcel Corp.	Satisfactory	Modest	BBB/Stable/--
Textron Inc.	Satisfactory	Modest	BBB/Stable/A-2
Harris Corp.	Satisfactory	Significant	BBB-/CWPos/A-3
L-3 Technologies Inc.	Satisfactory	Significant	BBB-/CWPos/--
Leidos Holdings Inc.	Satisfactory	Significant	BBB-/Stable/--
Spirit AeroSystems Inc.	Fair	Modest	BBB-/Stable/--
Huntington Ingalls Industries Inc.	Fair	Minimal	BBB-/Stable/--
BWX Technologies Inc.	Fair	Intermediate	BB+/Stable/--
AAR Corp.	Fair	Intermediate	BB+/Stable/--
CACI International Inc.	Satisfactory	Intermediate	BB+/Stable/--
Esterline Technologies Corp.	Fair	Intermediate	BB+/Stable/--

# Rated U.S. A&D Companies (cont.)

Nov. 1, 2018

	Business Risk	Financial Risk	Rating/Outlook
Kaman Corp.	Fair	Intermediate	BB+/Stable/--
ManTech International Corp.	Fair	Minimal	BB+/Stable/--
Moog Inc.	Satisfactory	Intermediate	BB+/Stable/--
Science Applications International Corp.	Fair	Intermediate	BB/CWPos/--
Perspecta Inc.	Satisfactory	Aggressive	BB/Stable/--
Booz Allen Hamilton Inc.	Satisfactory	Significant	BB/Stable/--
MRO Holdings Inc.	Weak	Significant	BB-/Positive/--
Maxar Technologies Ltd.	Fair	Aggressive	BB-/Stable/--
Advanced Integration Technology L.P.	Fair	Significant	BB-/Negative/--
The KeyW Corp.	Weak	Aggressive	B+/Stable/--
DynCorp International Inc.	Weak	Aggressive	B+/Stable/--
AerojetRocketdyne Holdings Corp.	Weak	Significant	B+/Stable/--
Consolidated Aerospace Manufacturing LLC	Weak	Aggressive	B+/Stable/--
Constellis Holdings LLC	Weak	Aggressive	B+/Stable/--
Engility Holdings Inc.	Fair	Aggressive	B+/Stable/--
KBR Inc.	Weak	Aggressive	B+/Stable/--
TransDigm Inc.	Satisfactory	Highly Leveraged	B+/CWNeg/--

# Rated U.S. A&D Companies (cont.)

Nov. 1, 2018

	Business Risk	Financial Risk	Rating/Outlook
Vertex Aerospace Services Corp.	Weak	Highly Leveraged	B/Positive/--
Kratos Defense & Security Solutions Inc.	Weak	Highly Leveraged	B/Positive/--
ADS Tactical Inc.	Weak	Highly Leveraged	B/Stable/--
Guidehouse LLP	Weak	Highly Leveraged	B/Stable/--
Peraton Corp.	Weak	Highly Leveraged	B/Stable/--
PAE Holding Corp.	Weak	Highly Leveraged	B/Stable/--
Wesco Aircraft Holdings Inc.	Weak	Highly Leveraged	B/Stable/--
StandardAero Aviation Holdings Inc.	Weak	Highly Leveraged	B/Stable/--
Forming Machine Industries Holdings LLC (Atlas Group)	Weak	Highly Leveraged	B/Stable/--
Propulsion Acquisition LLC (Belcan)	Weak	Highly Leveraged	B/Negative/--
WP CPP Holdings LLC	Fair	Highly Leveraged	B/Negative/--
Salient CRGT, Inc.	Weak	Highly Leveraged	B/Negative/--
CPI International Inc.	Weak	Highly Leveraged	B/Negative/--
Alion Science and Technology Corp.	Weak	Highly Leveraged	B-/Positive/--
Triumph Group Inc.	Weak	Highly Leveraged	B-/Stable/--
Dynamic Precision Group Inc.	Weak	Highly Leveraged	B-/Stable/--
Jazz Acquisition Inc. (Wencor)	Weak	Highly Leveraged	B-/Stable/--
Novetta Solutions LLC	Weak	Highly Leveraged	B-/Stable/--
Sequa Corp.	Weak	Highly Leveraged	CCC+/Stable/--

# Rated Non-U.S. A&D Companies

Nov. 1, 2018

	Business Risk	Financial Risk	Rating/Outlook
Airbus Group	Strong	Minimal	A+/Stable/A-1+
Rafael Advanced Defense Systems Ltd.	Fair	Modest	A-/Stable/--
Thales S.A.	Satisfactory	Modest	A-/Negative/A-2
Rolls-Royce PLC	Satisfactory	Modest	BBB+/Negative/A-2
BAE Systems PLC	Strong	Significant	BBB/Stable/A-2
Embraer S.A.	Satisfactory	Modest	BBB/Stable/--
Israel Aerospace Industries Ltd.	Weak	Significant	BBB-/Stable/A-3
Leonardo SpA	Satisfactory	Significant	BB+/Stable/B
CBC Ammo LLC	Weak	Aggressive	B+/Stable/--
MB Aerospace Holdings II	Weak	Highly Leveraged	B/Stable/--
Ural Optical & Mechanical Plant JSC	Weak	Highly Leveraged	B/Stable/--
Bombardier Inc.	Weak	Highly Leveraged	B-/Stable/--
Pioneer Holding LLC (Pattonair)	Vulnerable	Highly Leveraged	CCC+/Stable/--
Photonis Technologies SAS	Weak	Highly Leveraged	CCC+/Negative/--

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