Two Interesting Program Wins. Rhetoric and Reality

- Raytheon's DAPRA cyber award suggests it's doing something right, despite investor/analyzer misgivings about its cyber push. BWXT won a NASA contract that is encouraging for its diversification into services markets outside DoE.

- Gen. Dunford's comments on the F-35 buy should not be a surprise, and the 2% of GDP for defense in the U.K. Summer Budget 2015 needs to be unpacked in order to understand impact on industry. Part of that goal is being reached by including intelligence spending.

- Treasury data including outlays for June should be released July 13, and that will give insight into Q2 and 1H 2015 investment and O&M outlays.

- We watch with interest China's reaction to its stock market crash as attempts to blame hostile foreign forces may yet weigh positively on U.S. defense stock sentiment.

Week Ahead For Defense

Treasury releases outlay data on Monday for June so that will round out Q2 and 1H DoD investment and O&M outlays. Given news reports last week, Sikorsky's fate could also be known this coming week. The Treasury data will round out an earnings season preview we intend to publish. As for Sikorsky, we don't see an M&A chain reaction being triggered by other defense firms reassessing the strategic landscape if Lockheed Martin emerges as the highest bidder for Sikorsky. But we will also explore aspects of the Sikorsky deal in a separate note.

There are a number of DC and London events this coming week that could provide broader insight on factors driving defense. However, we doubt there is actionable news flow. Broader assessments of the global security picture should be aired by Christine Wormuth, DoD UnderSecDef for Policy at the July 13 CSIS event and the July 14 SASC confirmation hearings. There should also be newsflow for the RUSI July 15-16 Chief of the Air Staff's conference in London that possibly touches on European air modernization (Typhoon/Eurofighter upgrades, F-35, Rafale and Gripen).

We continue to watch, with interest, the situation in Greece and the gyrations in China's stock market. One of the more interesting aspects of China's market crash is...
that hostile foreign forces have been blamed. While this may be reminiscent of SE Asian responses in the 1997 financial crisis, the context of China's position in 2015 is entirely different, given changes in its relative military strength and base-building that has been going on in the South China Sea. Pakistan's 2008 attempt to halt its market decline by suspending trading is evidence of the futility of preventing price discovery. There was unrest too in July 2008 when Pakistani traders stormed the Karachi stock exchange. China's market problems may yet prove a sentiment positive for defense in 2015.

Minor Observations
There were a couple of events in the last week or so that didn't merit stand-alone research notes but are worth a comment because of their bearing on specific or general defense issues:

• Raytheon's DARPA win suggests they are doing something right in cyber. On July 8, DARPA announced that Raytheon was one of seven teams selected to play in the final round of its Cyber Grand Challenge. When this program was launched, 104 teams had registered. Raytheon is the only defense contractor in the final seven. We continue to believe that analyst/investor criticism of the Websense deal is shortsighted.

• BWXT win on SACOM evidence of diversification outside DoE. On July 9, BWX Technologies announced that its team (PAE Applied Technologies and BWXT) had been selected by NASA for the SACOM maintenance services contract. The press release noted a maximum potential value of $1.2 billion over nine and a half years. We don't know if this will be recognized as equity income from the joint venture or consolidated, but a SWAG on annual 2016-18 impact is roughly $2 million or so in operating income ($1.2b/9.5 * 0.8 * 4% /2). That's not material to earnings, but the NASA win is evidence that BWXT can diversify in services outside core Department of Energy programs.

• Dunford on F-35. In his written responses to questions submitted by the Senate Armed Services Committee before his July 9 confirmation hearing--specifically one on the F-35 requirement, Gen. Dunford stated that:

With projected adversarial threats challenging our current capabilities in coming years, the Joint Strike Fighter is a vital component of our effort to ensure the Joint Force maintains dominance in the air. Given the evolving defense strategy and the latest Defense Planning Guidance, we are presently taking the newest strategic foundation and analyzing whether 2,443 aircraft is the correct number. Until the analysis is complete, we need to pursue the current scheduled quantity buy to preclude creating an overall near-term tactical fighter shortfall.

That comment shouldn't come as a surprise to investors, but it's the first time we've seen a senior DoD official publicly question the U.S. requirement for 2,443 F-35s. We suspect that there is now a consensus that Lockheed Martin can get to a 150/year build rate by the end of this decade for the F-35 based on numbers suggested by block buy plans discussed earlier this year. That will rest on international demand and there are some uncertainties there. Next decade LRS-B and possibly unmanned programs should compete against the F-35 for resources, so the open debate remains how long the 150/year rate could be sustained--if it is achieved in the first place.

• U.K. defence spending. Release of the U.K. Summer Budget 2015 included a commitment to hold defense spending at 2% of GDP through 2020 and provide for 0.5% real growth. The Summer Budget on page 5 shows Defence at £45 billion but that figure includes foreign aid--Ministry of Defence's budget is probably closer to 35-36 billion. Intelligence spending is now being included counted in the 2% goal (it probably should have
been all along). The commitment is important but how it actual impacts defense contractors is not clear. There were reports and analysis earlier this year of outyear spending shortfalls including this analysis by RUSI so the top up may just fund existing program plans.

- **Rand and CSBA reports.** Rand finally made public a *lengthy report* it had conducted for the Air Force on the 2011 air campaign against Libya and CSBA released a report July 10 on *What it Takes to Win: Succeeding in 21st Century Battle Network Competitions*. We started to read the former and will get to the latter sometime this coming week, though we skimmed it. The Rand report includes a chapter on Libyan perceptions of NATO airpower. Libyan air defenses were ineffective much as "bean counts" of its inventory suggested otherwise. This comment on the a surface-to-air missile system deployed by the regime caught our attention:

  The S-200 (SA-5) was our only effective system. We reported a 60 percent readiness on the S-200; in fact, it was only 10 percent. We were all afraid of being shot, the officer stated.

The CSBA report includes observations on how deployment of SA-2 air defense systems to North Vietnam was a real game changer in the late 1960s. For investors, we suppose a take-away is not always to conflate exports of complex military kit with rising threats that could spur markets. There's always an "it depends" component on how it's employed.
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