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DEFENSE

Primes Appear to See Little Risk to Defense Outlook

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- We listened to defense officials and company webcasts or read transcripts of their presentation from the Credit Suisse Industrials conference on Dec. 2-4.
- As we have believed, timing of FY15 DoD appropriations appears immaterial for 2015 guidance assuming a bill is passed next week or another CR extends to early 2015.
- DoD is looking at possibly altering 50/50 share ratios on fixed price incentive contracts to encourage more cost take out. Contractors might earn more margin on such contracts, but they could face more risk if unsuccessful.
- Most outlooks remain benignly positive, but we remain intrigued by managements who are betting on market share gains and not just rising defense spending.

Credit Suisse held its Global Industrials Conference on Dec. 2-4. We either listened to webcasts or read transcripts of presentations by a number of defense company managements and several senior DoD officials. There is no change to our core views on defense:

- The FY16 DoD budget release in Feb. 2015 may support positive sentiment. Consensus is that there may be some relief from the Budget Control Act caps, but that may not be know until late 2015 and DoD is going to have to grapple for Congressional efforts to reverse cost savings. Stocks could fade later in the year if FY16 investment is closer to $160 billion and Congress continues to avoid cuts to older weapons systems and DoD overhead costs.
- The Defense Innovation Initiative is an emerging issue for defense and may result in less focus on capital deployment and more on relative growth and portfolio shaping within the sector.
- Global macro changes entail crosscurrents for defense. International defense remains important, but 2015 could see refinement of security needs & threat assessments

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As for the conference, here is what we found of interest:

Timing of FY15 DoD appropriations is immaterial and a budget should be done soon, but there was more variability for FY16 and beyond. We heard little concern about material risk regarding preliminary 2015 expectations and timing of the FY15 DoD appropriations. Such views are appropriate, in our view. As for FY16 and beyond, no management opined that the budget and outyear plan could be above the plan submitted last spring by DoD, but none saw it below the budget caps. Consensus was that Congress may provide some funding above the FY16 budget caps, but Exelis and Boeing thought DoD would be funded at budget cap levels.

No management addressed long-term budget pressures that could pressure DoD investment from higher compensation costs and costs associated with sustaining older weapons and excess infrastructure that result from Congress not approving DoD requests to save costs in these areas.

DoD is looking at changes to share lines in contract incentives. UnderSecDef for AT&L Kendall covered a lot of familiar ground in his presentation, but the one new comment was that he wanted to look at the 50/50 share ratio used in fixed price incentive contracts. The share ratio entails how excess costs could be shared up to a ceiling amount (usually 120%). Kendall noted that he wanted to change this ratio but didn't quantify or in what circumstances. The ratio could be changed to further incentivize cost reduction which may be good in some instances, but it also could penalize contractors that execute to higher than anticipated cost levels. Fixed price incentive contracts are generally used where most development risk has been retired, but "where actual costs on firm fixed price contracts have varied by more than four percent from the costs considered negotiated." In FY13, 10% of total DoD contract by dollar value were fixed price incentive types. So this shouldn't be a big issue, but it's a watch issue for contractors with major programs in LRIP.

Maybe this is a difference is messaging, but perception remains some firms emphasize investment and share gain while others focus on current programs. L-3 stated that "We're focused on expanding those market positions, gaining market share." Raytheon noted that it has a "strategy for technology" that included internal research and development, capture of DoD customer-funded R&D (e.g. DARPA programs) and international funded development. Exelis again noted it was stepping up company-funded R&D in 2015. This doesn't mean that other companies didn't discuss current programs or programs that replaced older ones they've built, but there is a nuance here.

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