

# The View From Wall Street: What Investors Think of the Defense Sector

*Presented by:*

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# Defense Investment Dynamics



# Mental Models

## *A Way of Approaching the Stock Market*

- **Investors approach the stock market with a set of “mental models”**
  - composed of rules of thumb, images and mental tools
- **Mental models are necessary to sort through and process a huge amount of information within a short time frame**
- **Mental models are generated**
  - **Internally by investors - experience, trial and error, “conventional wisdom”**
  - **Externally by the aerospace/defense industry - raw data, management, investor relations, communications team via the press**



# Mental Models

## *Any of These Sound Familiar?*

- **The commercial aerospace industry is a deeply cyclical industry - prone to booms and busts**
- **Defense companies are “sexy utilities” - they are stable, never miss numbers and predictable**
- **Boeing is a commercial aerospace company (corollaries: never invest in Boeing during a downturn in commercial aircraft orders or when R&D as a percentage of sales is going up)**
- **The defense budget is in decline**

**MENTAL MODELS ARE OFTEN SLOW TO CHANGE!**



# Defense Investment Environment

## Relative Stock Performance

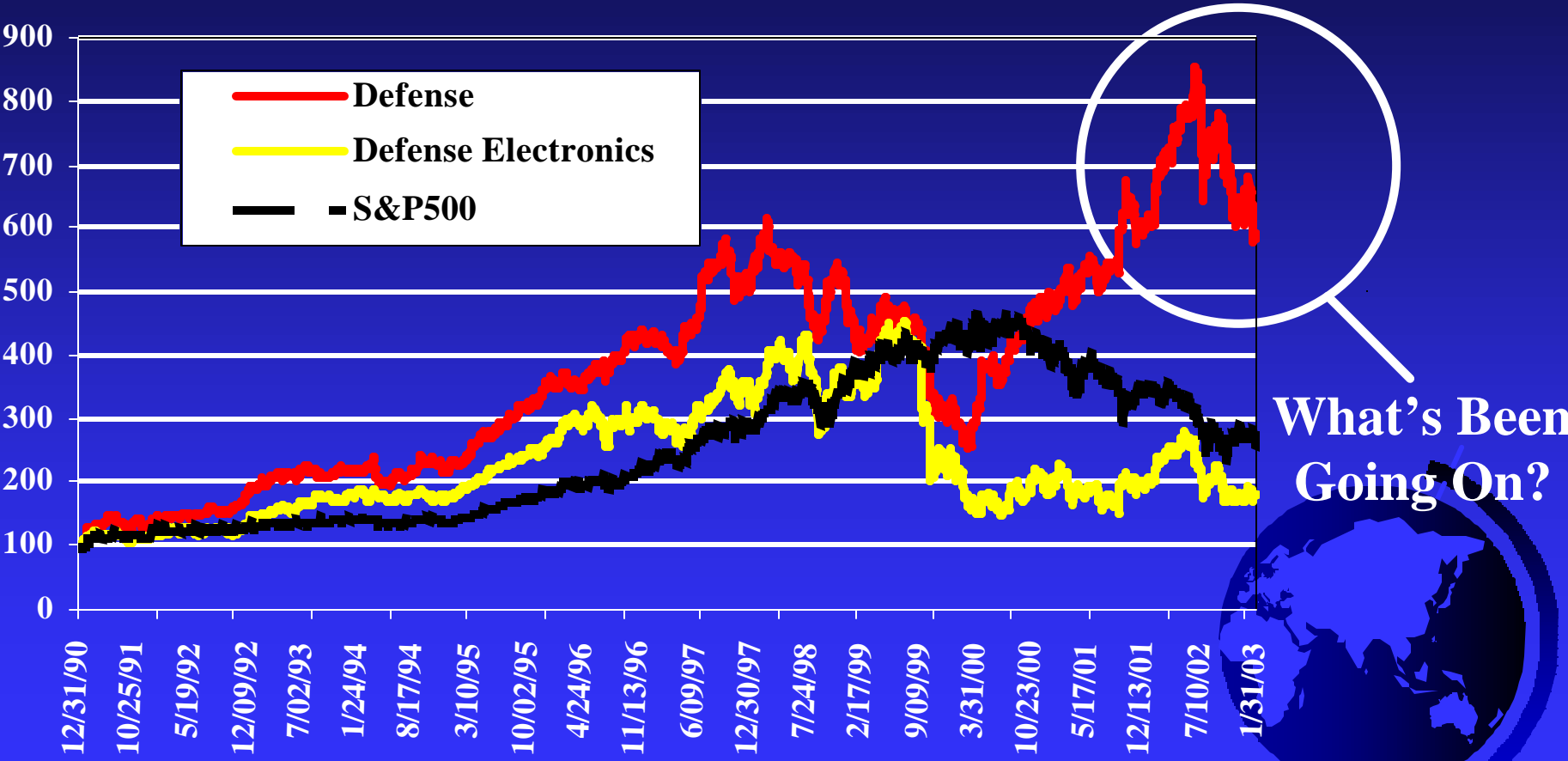


Defense = Alliant Techsystems, General Dynamics, Grumman, Litton, Lockheed Martin, Martin Marietta, Northrop, Northrop Grumman, Newport News

Defense Electronics = E-Systems, L-3 Communications, Logicon, Loral, Raytheon, Tracor

# Defense Investment Environment

## Relative Stock Performance



What's Been Going On?



Defense = Alliant Techsystems, General Dynamics, Grumman, Litton, Lockheed Martin, Martin Marietta, Northrop, Northrop Grumman, Newport News

Defense Electronics = E-Systems, L-3 Communications, Logicon, Loral, Raytheon, Tracor





# ATK (Alliant Techsystems)



2Q00	3Q00	4Q00	1Q01	2Q01	3Q01	4Q01	1Q02	2Q02	3Q02	
1.6%	2.5%	3.4%	3.6%	2.9%	19.9%	24.3%	20.8%	23.6%	28.4%	Mo/Aggressive
9.1%	16.0%	18.2%	20.2%	19.0%	20.7%	22.1%	22.6%	25.2%	26.2%	Growth
39.0%	34.6%	35.9%	37.0%	41.1%	29.7%	21.2%	24.1%	24.2%	22.4%	GARP
36.4%	33.0%	27.7%	23.1%	18.2%	12.5%	14.6%	14.6%	10.6%	10.4%	Value
13.8%	13.9%	14.8%	16.1%	18.7%	17.2%	17.7%	17.9%	16.3%	12.6%	Index
100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	



1Q00	2Q00	3Q00	4Q00	1Q01	2Q01	3Q01	4Q01	1Q02	2Q02	
0.5%	2.5%	2.6%	2.4%	2.5%	2.9%	4.5%	4.7%	4.0%	5.4%	Mo/Aggressive
9.8%	8.9%	7.1%	7.8%	10.3%	11.0%	12.6%	14.8%	16.5%	17.9%	Growth
10.3%	10.4%	10.3%	10.2%	10.9%	12.1%	13.2%	15.6%	16.8%	16.6%	GARP
45.7%	46.6%	51.1%	49.7%	46.3%	44.4%	39.9%	33.8%	33.1%	31.0%	Value
33.7%	31.6%	28.9%	29.8%	30.0%	29.6%	29.8%	31.1%	29.6%	29.2%	Index
100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	

# L-3 Communications



1Q00	2Q00	3Q00	4Q00	1Q01	2Q01	3Q01	4Q01	1Q02	2Q02	
4.8%	9.9%	13.8%	14.6%	17.0%	19.5%	23.4%	18.4%	15.3%	17.2%	Mo/Aggressive
36.5%	38.2%	33.7%	34.6%	37.1%	34.7%	28.4%	28.3%	32.5%	27.1%	Growth
26.7%	23.8%	23.0%	24.6%	22.3%	23.6%	27.2%	27.7%	23.0%	24.0%	GARP
23.0%	18.7%	18.9%	15.4%	10.5%	10.8%	10.2%	14.2%	16.7%	12.1%	Value
8.9%	9.4%	10.6%	10.8%	13.1%	11.4%	10.8%	11.3%	12.6%	19.7%	Index
100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	

# Defense Investment Environment

## *Mental Models Used By Aggressive Growth/Mo*

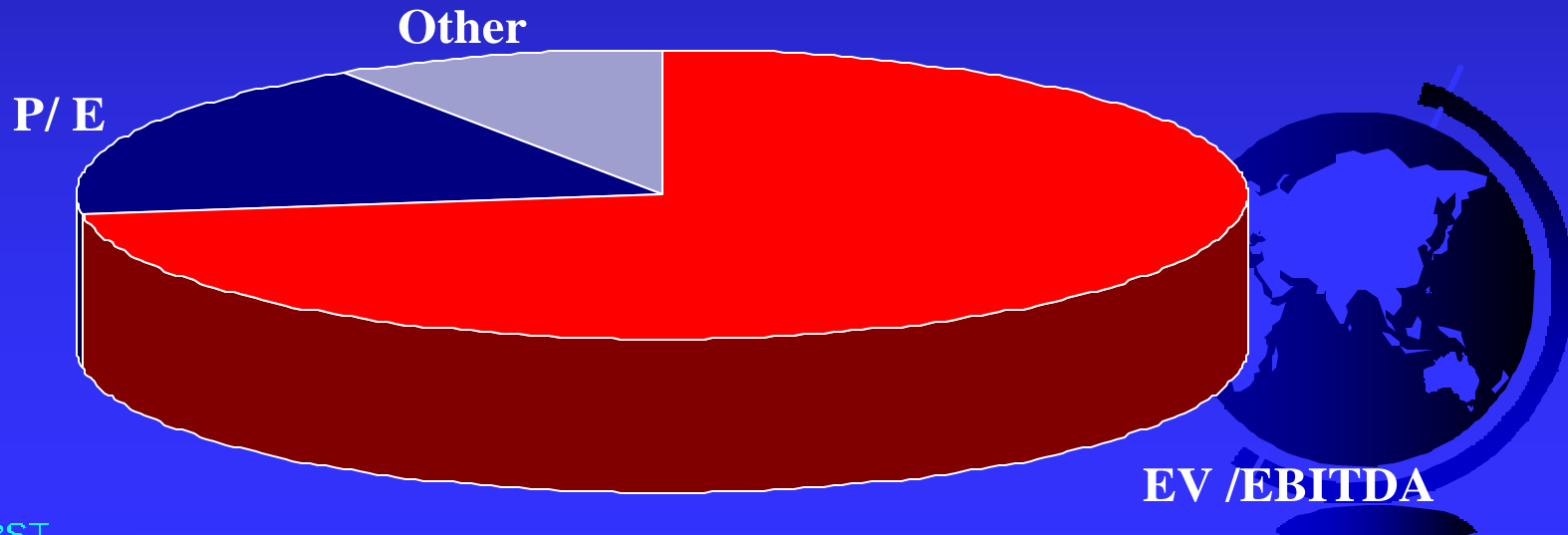
- **Acceleration is key**
  - **6.5% growth FY02 over FY01, 18.8% FY03 over FY02**
  - **What about FY04 over FY03?**
- **Focus on P/E and GAAP EPS**
- **Renters, not owners**



# Defense Investment Environment

## *Investors Still Prizes the Industry for its Cash Flows*

- 75% of Investor Polled Said They Used:
  - ◆ Discounted Cash Flow of Free Cash Flow Analysis or
  - ◆ Price to EBITDA (proxy for cash flow) Analysis or
  - ◆ Cash Earnings (proxy for cash flow) Analysis or ROIC
- Used to be 100%



# Defense Investment Environment

## *Mental Models Used By Aggressive Growth/Mo*

- **Focus on P/E and GAAP EPS**

- **PENSIONS PENSIONS PENSIONS**

- **LMT 2003 GAAP EPS = \$1.72 vs. economic = \$3.42**

- **RTN 2003 GAAP EPS = \$1.65 vs. economic = \$2.17**



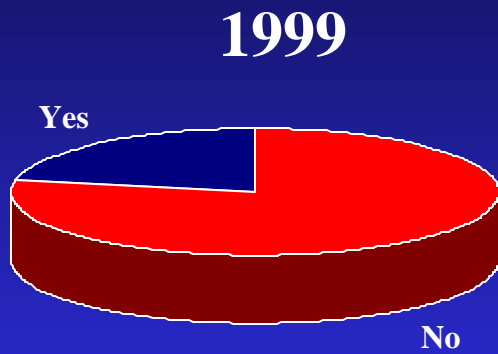
# Defense Investment Environment

- **What do other/the rest of the investors think?**

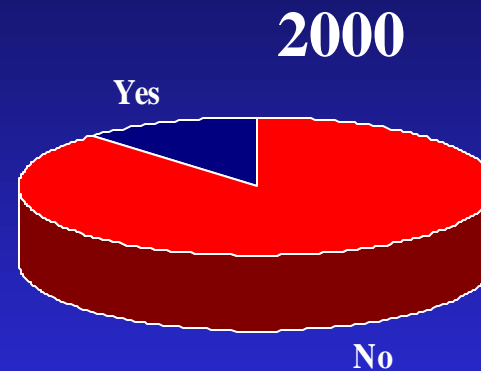


# Defense Investment Environment

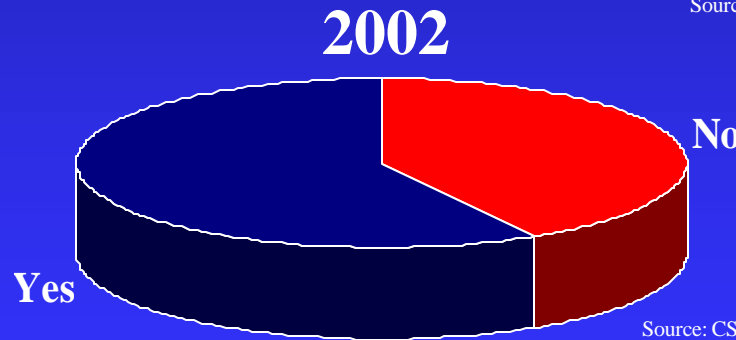
- Do you perceive the aerospace/defense industry to be a growth industry?



Source: MSDW survey



Source: CSFB survey



Source: CSFB survey

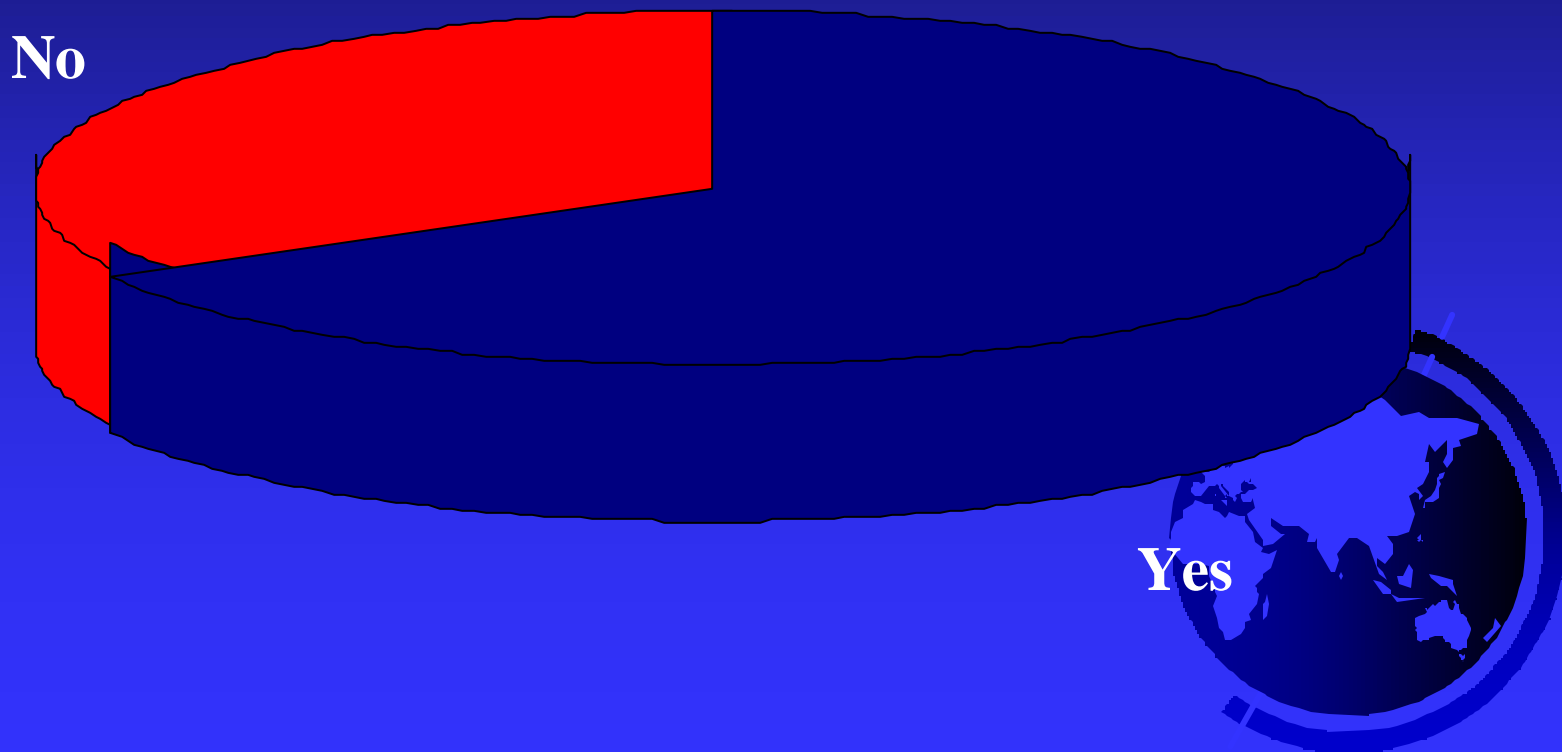


- “Long term no”
- “In an upcycle now, but no reason to grow equal to GDP over time”



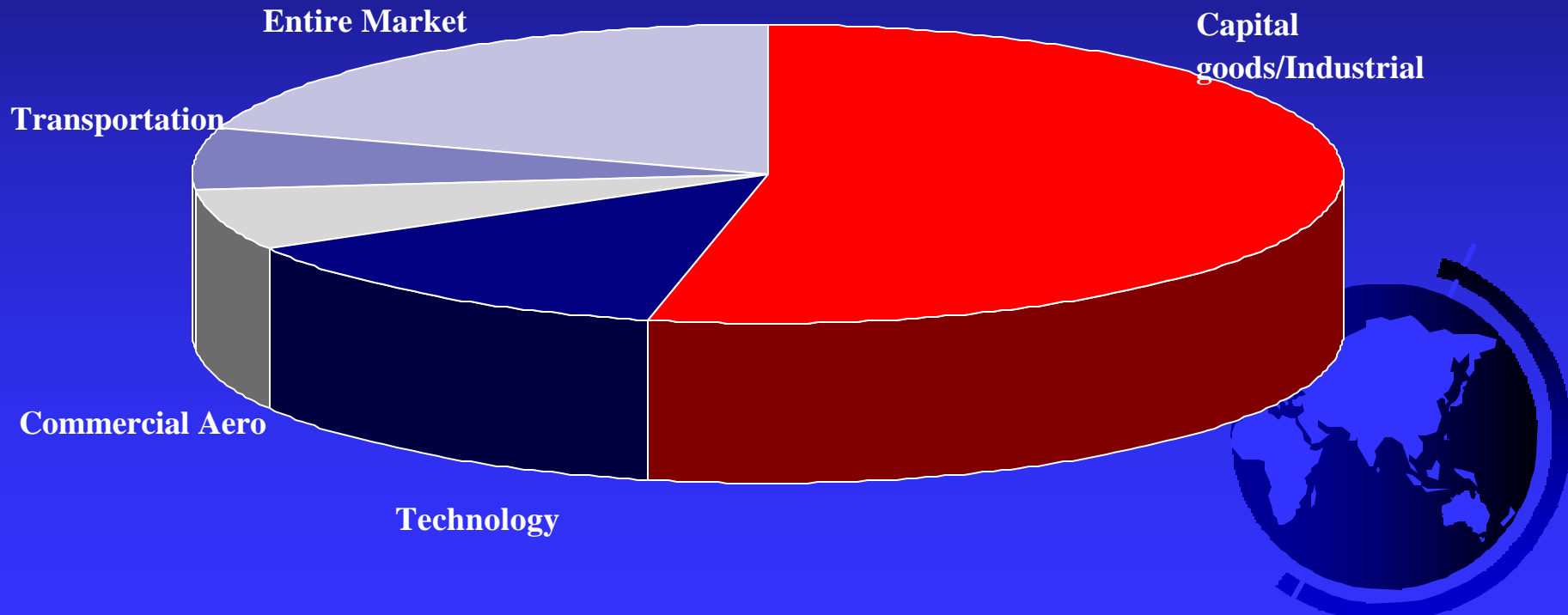
# Defense Investment Environment

- Are you invested in the defense sector now?
- “Valuations too high”



# Defense Investment Environment

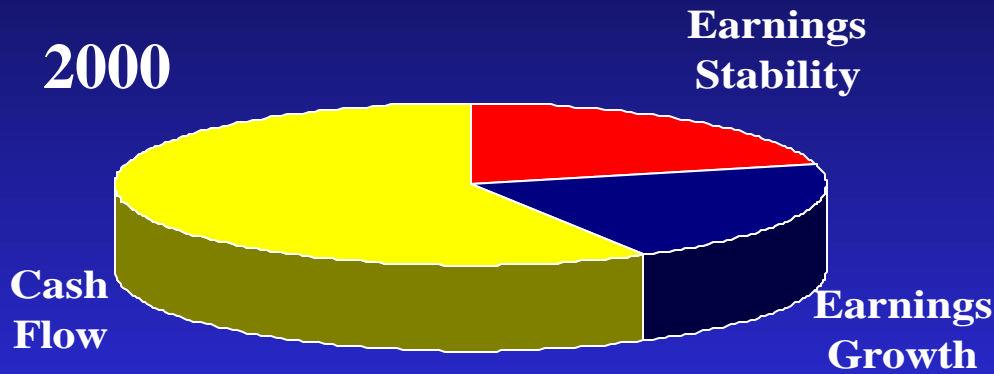
- What are the alternative investments when you consider the defense sector?



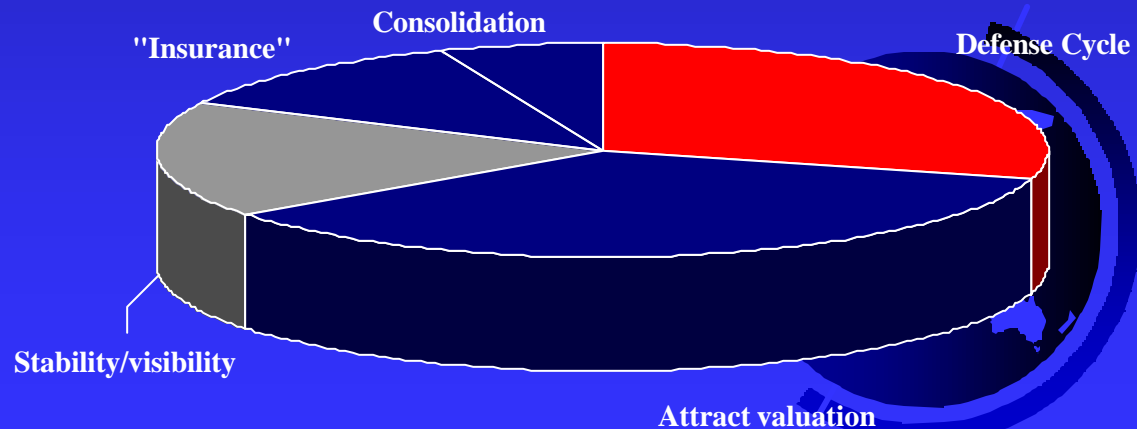
Source: CSFB survey

# Defense Investment Environment

- Why are you invested in the sector?



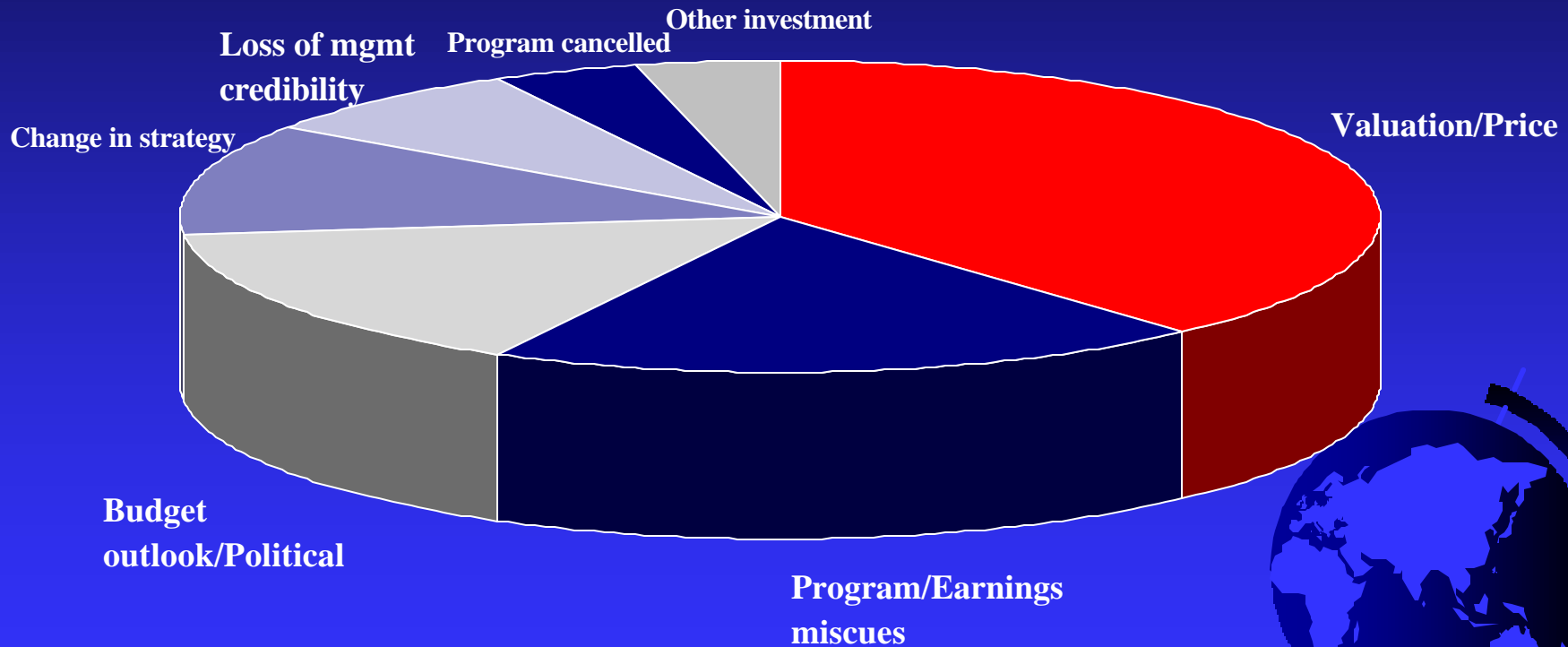
2002



- “To make money!!!!”

# Defense Investment Environment

## ● Why would you sell your defense investment?



Source: CSFB survey

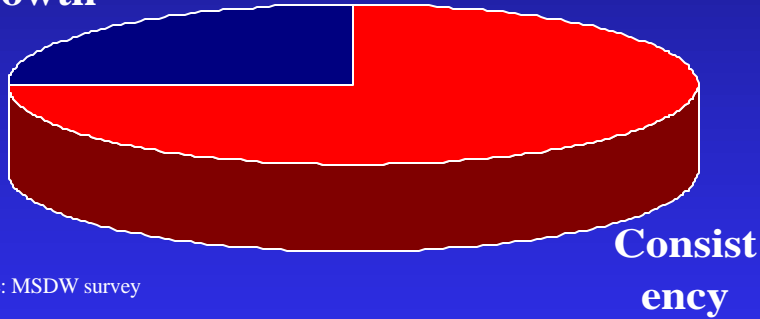
# Defense Investment Environment

*Investors Prize the Industry for its Stability*

- What is more important to you: top-line growth or consistency of earnings?

1999

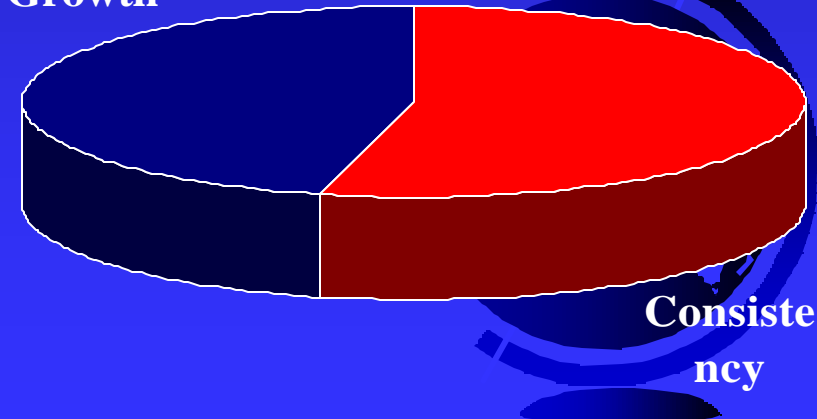
Growth



Source: MSDW survey

2002

Growth

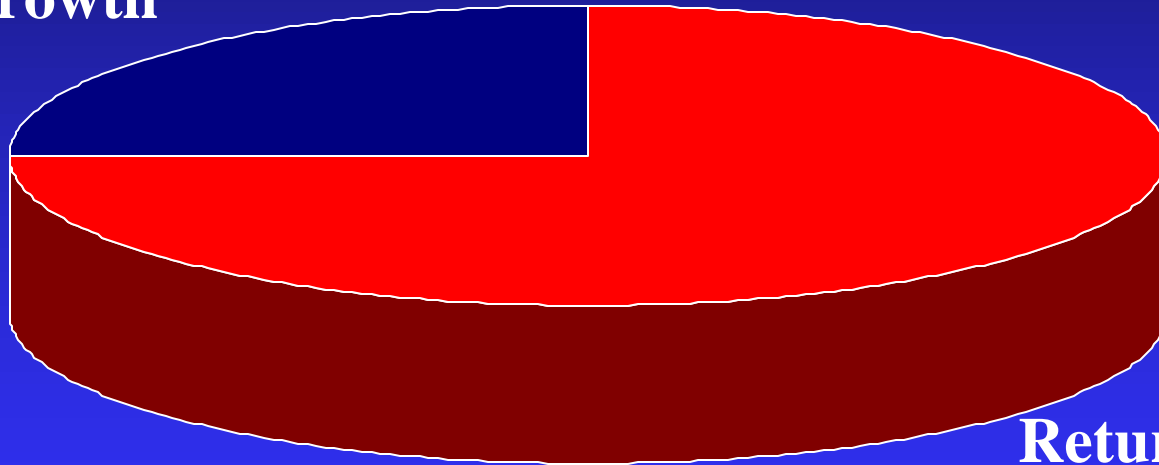


“Predictability of source and level of earnings, as opposed to smoothness”

# Defense Investment Environment

- What is more important, growth or return on capital?

Growth



Return on  
Cap



Source: CSFB survey

# Defense Investment Environment

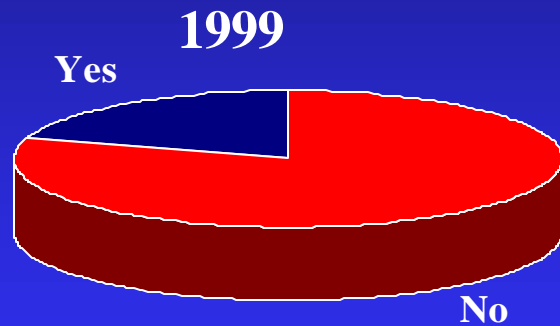
## *Investor Confidence Rebuilding*

- **Do you think aerospace/defense companies are well managed?**

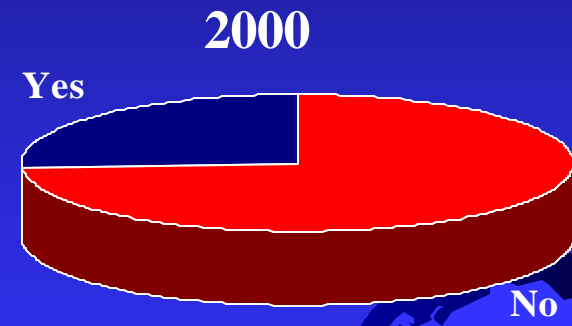
“Surprises undermined the confidence in consistency of earnings”

“Too insular”

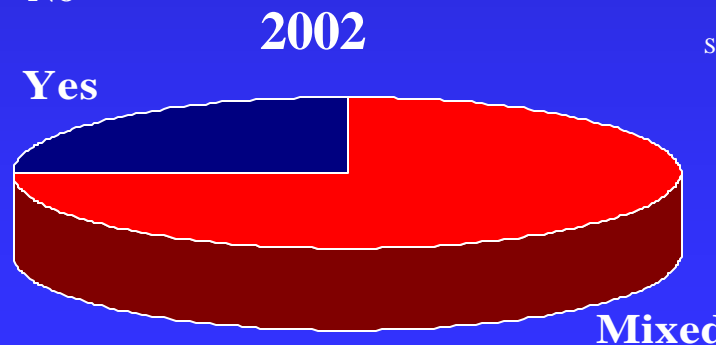
“Small companies better managed than the big ones”



Source: MSDW survey



Source: CSFB survey



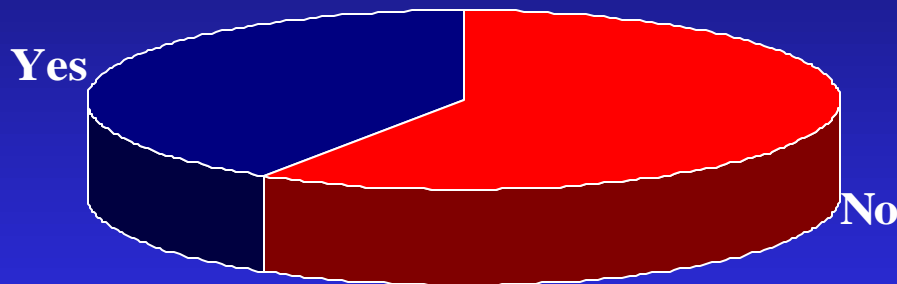
“Getting better”

# Defense Investment Environment

## *And Government Policy is an Issue*

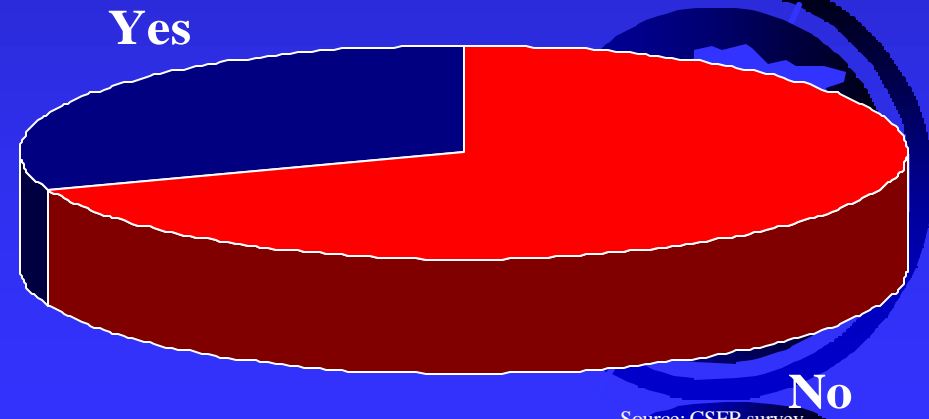
● Do you believe the defense industry earns appropriate margins for the risk taken?

2000



“Yes – given the capital required”  
 “Not many industries where R&D is funded by customer”  
 “Closed market, rarely lose money...generate cash at minimal risk”

2002



“No – given long development cycles”  
 “Margins too low given the higher risks of the annual budget process and the limited number of programs completed”  
 “Industry too politicized, which may never be solved...improved ROIC would help”

Source: CSFB survey



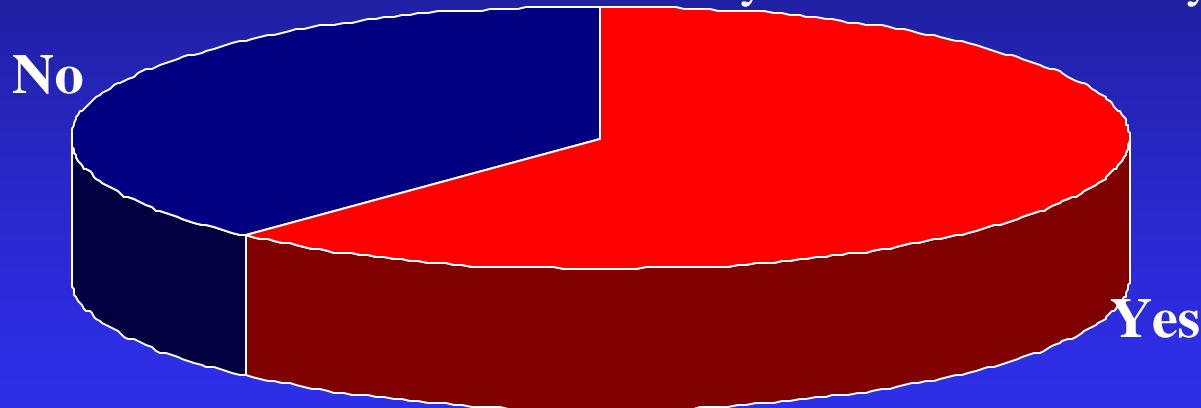
# Defense Investment Environment

## *And Government Policy is an Issue (2)*

### ● Do you believe the defense industry is healthy?

NO – “Industry still needs to deleverage”

“The length of the procurement process too long, hurts the industry”      “Should always attract capital”



YES – “budgets, cash flow, earnings and sentiment improving”

“Balance sheets repaired”

“Now that consolidation is over”

“Procurement reforms and management changes improving returns”

“Managements are tougher and more disciplined”



Source: CSFB survey

# Defense Investment Environment

- **Key Questions:**

- **Future growth rates?**

- **Impact of Iraqi War?**

- **What is the five year case?**



# Leveraging the Financial Markets

## “Financial Jujitsu”



# Financial Jujitsu

- ◆ How does the Munitions Buying Community use an understanding of the financial motivations of its supplier base to further DoD goals:
  - ◆ Technology innovation
  - ◆ Assurance of supply
  - ◆ Best value
  - ◆ On time, on budget



# Financial Jujitsu

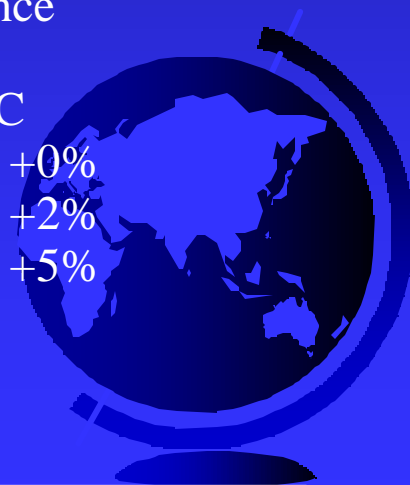
- ◆ Tie rewards that mean something to the industry to performance goals
  - ◆ Munitions – technology/program milestones
    - Buyers
      - on time delivery
      - cost performance
      - innovation
  - ◆ Industry
    - timing of cash payments (Invested Capital issue)
    - advance payments for next phase as reward (Invested Capital)
    - extra normal margins (Return issue)
    - share of savings (Return issue)
    - share of investment (Invested capital)



# Financial Jujitsu

- ◆ Use rewards/penalties that make financial sense, are fair and attractive to future investment environment
  - ◆ Tie return to cost of capital
    - ◆ Defense industry competing for investment, resources and talent versus the rest of the economy
      - Low Risk work – Cost of Capital +/-XX% (small single digit)
      - Medium Risk work – cost of capital +/- XX% (say 4-6%)
      - High risk work – cost of capital +/- XX% (upper single/double digit)
  - ◆ A more nuanced system that takes into account past performance

	A	B	C
Low Risk	CoC + 3%	CoC + 2%	CoC +0%
Medium	CoC + 5%	CoC + 4%	CoC +2%
High	CoC + 8%	CoC + 7%	CoC +5%



# Financial Jujitsu

- ◆ Fix the “throw aways” that don’t impact policy goals but are important to industry
  - ◆ Paid cost rules
  - ◆ Facilities as a determinant of margin rates
  - ◆ Progress payments
  - ◆ Etc. (see Defense Science Board study)



# Financial Jujitsu

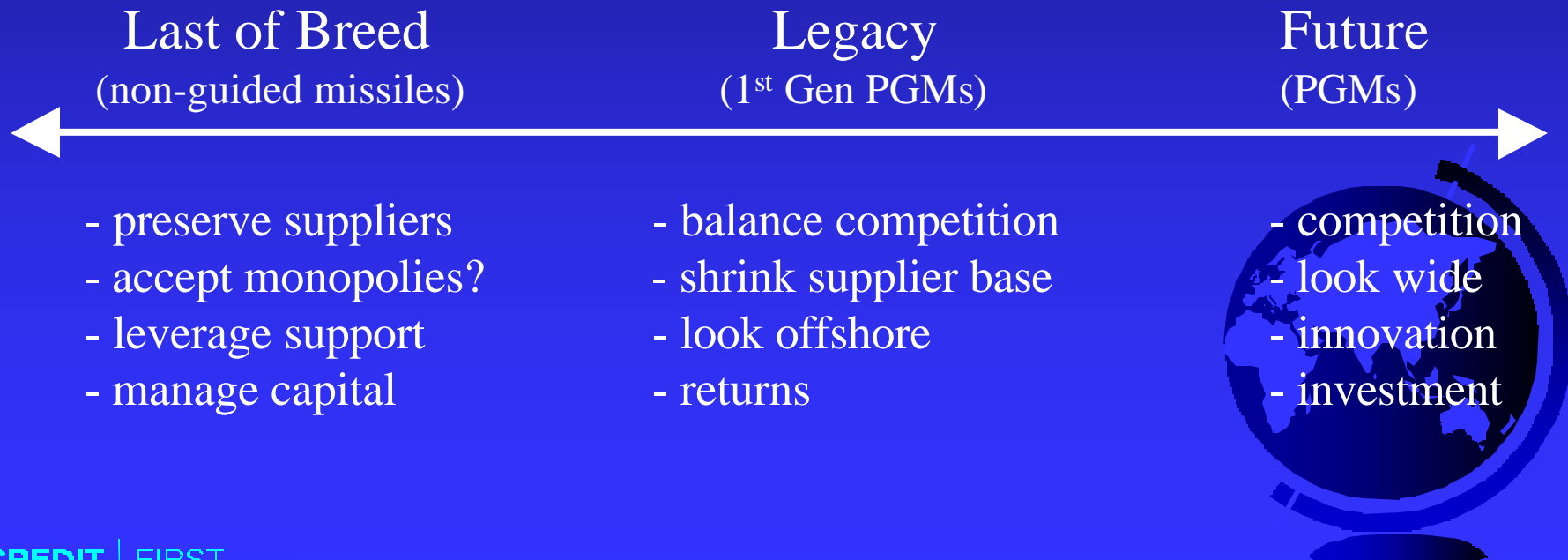
- ◆ “Out of the box acquisition mechanisms” for “out of the box ideas”
  - Prize money (to kick start technology)
  - Venture investment (to kick start technology)
  - Leasing
  - Real options (to price surge capacity)



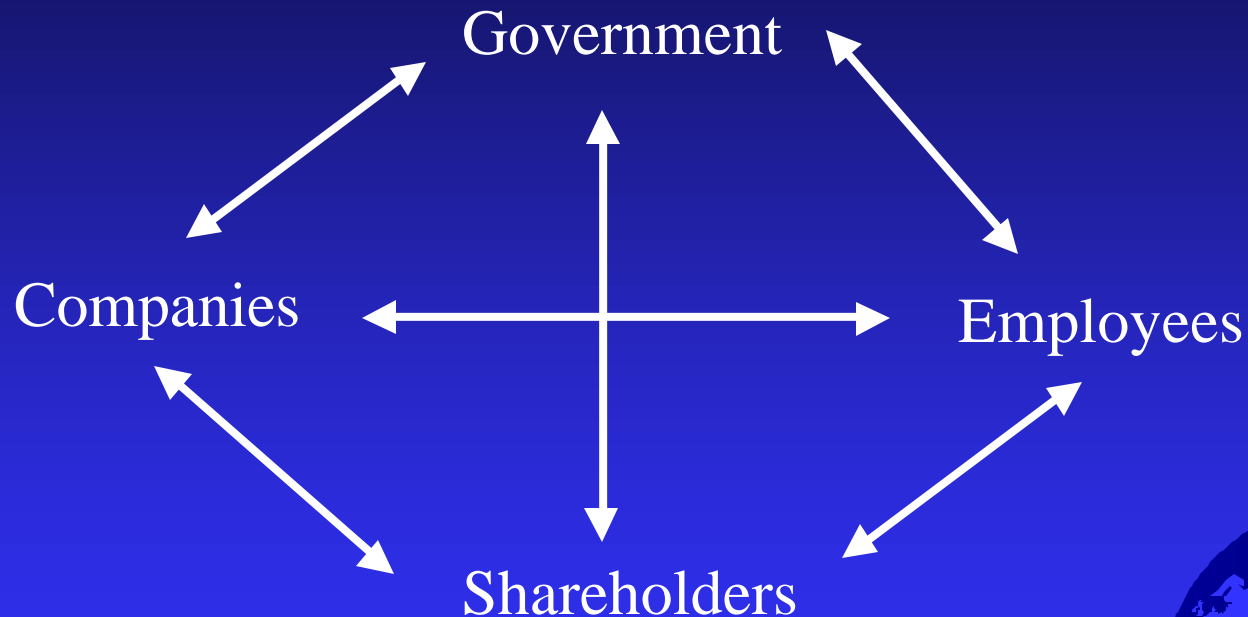


# Financial Jujitsu

- ◆ You need a spectrum of management techniques for the industrial base
- ◆ Look to the product cycle



# Creating Value is NOT a Zero-Sum Game



**A healthy industry is able to attract investment/shareholders, lowering cost of capital, enabling it to invest more in R&D and attract talent, and be a better contributor to national security**

