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High Yield | Aerospace & Defense
North America

DynCorp International (DCP)

Continuing Uncertainty Keeps us on Sidelines; Updating Forecasts

- **What's New?** — Over the past two months, DynCorp 10.375% senior notes have sold off 14 points from their pre-earnings level of \$105. At current mid-market price of \$90.5, the paper yields 14.6% to its 2017 maturity date (575bp incremental yield vs. CCC-rated Index). In addition to weak 2Q results reported on Aug 11 (see [link](#) to our note), CEO departure(s), and a downgrade by Moody's on Aug 15, negative headlines relating to lost contracts and a DoD investigation into overcharges for an prior contract (2007-2013) have negatively impacted trading levels. We see potential for continued volatility and prefer to remain Neutral on the 10.375% senior notes, despite tempting yields.
- **What's Next? Potential Upcoming Events** — (1) Potential amendment of 2016 term loan covenants to provide additional headroom (3Q14). (2) Announcement of new CEO and/or potential contract wins/losses (could be positive or negative). (3) Headline risk associated with pending DoD investigation for overcharges. (4) Potential new Iraq-based contracts resulting from US war against Islamic State (IS). DynCorp's opportunity would depend on whether US troops are deployed and/or the type contract vehicle in question. Keep in mind the current plan to deploy 1,600 troops represents ~1% of the troop level during 2008 peak. (5) Lastly, another industry data point could emerge with the pending spin-off of Vectrus (pure-play military and government services provider) from its parent, Excelis (*Sep 27 distribution date*). *Note, Vectrus' 2014 revenue guidance implies 20-25% y-o-y decline owing to pressures in Afghanistan and Middle East.*
- **Updated 2015 Estimates** — On the following page, we provide updated 2015 estimates across three scenarios: base case (\$88mm EBITDA), lower range (\$65mm EBITDA), and upper range (\$104mm EBITDA). Importantly, in our base-case, we assume DynCorp generates ~\$40mm of free cash flow and continues to pay-down debt in 2015, resulting in 5.0x net leverage through the 10.375% senior notes (at year-end 2015) vs. 4.0x today. See Figures 2 & 3 for details. Recall, mgmt. also has ability to buy-back ~\$50mm worth of bonds (although low probability).
- **Re-iterate Neutral on 10.375% Senior Notes** — The timing of any positive catalysts remains unclear and following an anticipated 32% decline in 2014E EBITDA, the business lacks earnings visibility entering 2015. While we acknowledge the offset from FCF generation (and debt pay-down), DCP could end 2015 with net leverage anywhere between 4.2x and 7.0x. Note, based on a 5.0x EV multiple, recovery on the 10.375% notes could range from 71% to fully covered.

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L+450bp/1.75%	Term Loan		7/7/2016	Ba3(S)/B+(S)	\$217	99.750	6.38%		
10.375%	Sr Nts	Neutral (2)	7/1/2017	Caa1(S)/CCC+(S)	\$455	89.000	15.36%	1426	7/1/2017

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Financial Projections & Trading Charts

Figure 1. DynCorp Financial Summary

	Fiscal Year End Dec 31				Quarterly						lower range	base case	upper range
	2010A	2011A	2012A	2013A	1Q14A	2Q14A	3Q14E	4Q14E	LTM	2014E	2015E	2015E	2015E
Operating Statistics													
Revenue	\$3,383	\$3,721	\$4,044	\$3,287	\$613	\$591	\$550	\$550	\$2,682	\$2,304	\$1,613	\$1,912	\$2,073
y-o-y % change	19.2%	10.0%	8.7%	(18.7%)	(34.3%)	(32.6%)	(28.3%)	(22.7%)		(29.9%)	(30.0%)	(17.0%)	(10.0%)
Adj. EBITDA	220	194	196	169	35	30	25	25	131	114	65	88	104
y-o-y % change	(6.7%)	(11.9%)	1.4%	(14.1%)	(35.1%)	(38.9%)	(15.7%)	(32.6%)		(32.2%)	(43.6%)	(23.1%)	(9.3%)
Margin	6.5%	5.2%	4.9%	5.1%	5.6%	5.0%	4.5%	4.5%	4.9%	5.0%	4.0%	4.6%	5.0%
Cash	100	81	120	172	122	153	72	162	153	162	180	181	181
Secured Debt	569	417	327	277	262	217	202	187	217	187	177	167	162
Unsecured Notes	456	456	456	455	455	455	455	455	455	455	455	455	455
Total Debt	1,024	873	783	732	717	672	657	642	672	642	632	622	617
Credit Statistics													
LTM													
Net Secured Debt / EBITDA	2.1x	1.7x	1.1x	0.6x	0.9x	0.5x	1.0x	0.2x	0.5x	0.2x	0.0x	-0.2x	-0.2x
Net Total Debt / EBITDA	4.2x	4.1x	3.4x	3.3x	4.0x	4.0x	4.6x	4.2x	4.0x	4.2x	7.0x	5.0x	4.2x

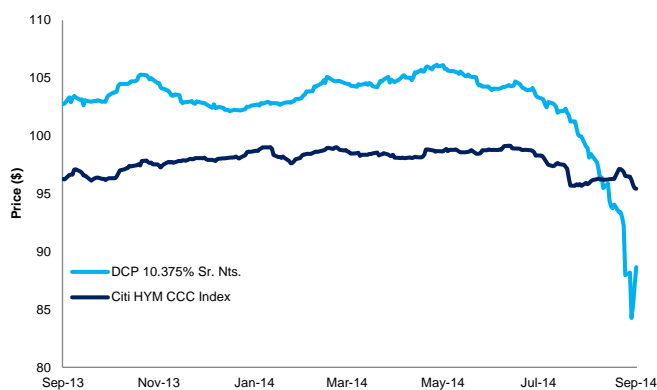
Source: Citi Research, Company Filings

Figure 2. Cash Flow Forecast

	2013A	2014E	lower range	base case	upper range
	2015E	2015E	2015E		
EBITDA	\$169	\$114	\$65	\$88	\$104
Cash Interest	(72)	(63)	(60)	(59)	(58)
Cash Taxes	(14)	(15)	(8)	(11)	(13)
Working Capital	70	66	40	30	20
Other	(15)	(6)	(2)	(2)	(2)
Cash Flow from Ops	138	96	34	46	50
Capex	(8)	(7)	(6)	(6)	(6)
Free Cash Flow	130	88	28	39	44
Debt Paydown	(50)	(90)	(10)	(20)	(25)

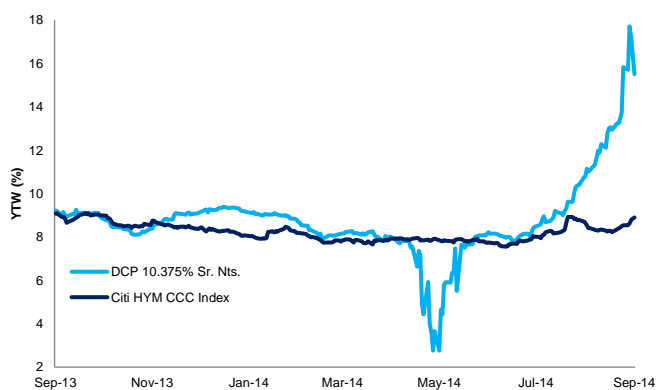
Source: Citi Research, Company Filings

Figure 4. DynCorp 10.375% (Price)



Source: Citi Research, Bloomberg

Figure 5. DynCorp 10.375% (YTW)



Source: Citi Research, Bloomberg

Appendix A-1

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Citi Research US High Yield Issue Coverage	24%	63%	12%
% of companies in each rating category that are investment banking clients	78%	78%	59%

DynCorp International Inc. (DCP) — Issuer Portfolio Weighting and Issue Rating History

High Yield Credit Research

Analyst: Manish A. Somaiya

Issuer		Issue				
Weighting	Date	Coupon	Description	Maturity	Rating	Date
UW	05-Oct-12	10.375%	Sr Nts	01-Jul-17	Neutral (2)	05-Oct-12

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