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Aerospace & Defense (Citi)
North America

Brace Yourself, This Could Get Messy

Budget base case intact, but look for buying opportunities

- **What's New** — We spent the last two days in DC speaking with companies and other defense industry stakeholders. We've come away with an incrementally negative view of the *near-term* budget battle, appreciating the appearance that neither political party is prepared to negotiate in earnest before sequester hits on March 1. Only after it has hit do we see more leeway for a deal that undoes at least a portion of the sequester cuts. We're still long the primes, but we think it will be at least 4-8 weeks before the clouds begin to clear, so we're looking for buying opportunities as the messy headlines weigh on sentiment. We continue to believe in our base case outcome: an eventual deal flat-lining the budget for 10 years. But it will likely take some weeks, and some more Congressional chaos, to get there.

- **Industry Perspectives** — We met with LMT, Boeing, NOC, GD, CACI, and Booz Allen. Generally, companies are doing their best to prepare for a variety of sequester scenarios, highlighting that they're ready to right-size the business in response to any budget reductions. Short-cycle, services-oriented businesses are already feeling the pinch as DoD starts to reduce outlays and new procurements. Meanwhile, longer-cycle hardware providers have yet to feel material pressure. From the companies' perspectives, the most unacceptable part of sequester is the cadence, not the content, of the cuts. There are budget reductions to be made, but it would be preferable to let DoD choose what to cut vs. the peanut-butter approach. The current environment is far from ideal, but the primes are still set to put their cash to work to drive attractive cash returns to shareholders as M&A is still not a priority in this uncertain environment.

- **Sequester Outlook** — The law calls for a ~7-10% reduction across the budget. DoD has already said that it will save money at first by skipping/delaying training, maintenance, deployments, and various sorts of support spending. Soon after, we'd expect to see more pressure on short-cycle services businesses. And only a few months after sequester would we expect material reductions in investment account purchases as DoD sorts through contracts & clauses. In our view, companies with high obligated backlogs and longer-cycle businesses likely fare best in this scenario (see our sequester investment framework: Making a List and Checking it Twice).

- **Congressional Chaos** — GOP strategy appears to be to let sequester take effect to force the President to negotiate in earnest on long-term entitlement reform. This negotiation would only happen in March as part of the efforts to avoid a government shutdown when the CR runs out on March 27. Meanwhile, the Democrats have proposed a 1-year plan that disarms sequester by implementing the Buffet rule, axing agricultural subsidies, and cutting defense by $27.5b over FY15-21. In our view, this proposal is dead on arrival since the GOP believes that after the fiscal cliff deal that raised taxes, there is no more room for revenues in future deficit reduction.

- Industry Overview

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Trying to See the Sequester

Neither side appears ready to deal in earnest, so sequester likely takes effect on March 1, with the rest of the month spent voiding government closure & at least partially reversing sequester.

DC for the most part appears ready for sequester to technically go into effect on March 1 with the expectation that Congress will come back in March and do a deal that avoids a government shutdown at the end of the month and mitigates the impacts of sequester by either restoring some budget or at the very least offering the DoD some leeway in applying the cuts (vs. the peanut butter approach required by current law). Apparently absent from the debate is much consideration of the economic and national security impacts of sequester going into effect which was laid out in Congress by the Joint Chiefs and other Departmental leadership over the last 3 days.

In our view, companies with large backlogs and long-cycle products are less exposed to sequester vs. short-cycle services exposure.

Generally speaking, long-cycle and large backlog defense companies commented that budget sequestration this year would have a limited impact on 2013 results given how budget authority spreads across multiple years. However, it's apparent that short-cycle services businesses are relatively easy targets for near-term money-saving vs. longer-lived production contracts.

What's priced in?

Defense stocks are pricing in perpetual declines in free cash flow. We believe this is overly negative even in the event of sequester.

It's admittedly difficult to pinpoint what effect sequester would have on fundamental business operations given the multitude of scenarios in play. Our base case of a flat 10Y budget, as laid out in our Feb 8 global weekly (see: It's right in front of your nose, if you'd only just open your eyes), is reflected in our current estimates for our defense companies under coverage. Assuming this base case of flat budgets pans out, the market is too negative on defense, pricing in a perpetual reduction in free cash flow anywhere from 1-7% (see Figure 1).

Even if we adjust for the potential impact of sequester, we still consider the market to be overly negative. For instance, haircutting the starting point (2013E UFCF) in our zero-growth model by 15% to account for budget reductions, still implies that the market is pricing in perpetual reductions for the defense primes except for LMT where the market prices in a flat cash outlook (Figure 2). And in the event of sequester, we remind investors that the budget is actually allowed to grow thereafter and that attractive pension dynamics support cash growth beginning in 2014.

Thus, we consider any market valuation that implies perpetual reductions in free cash flow in our base case or in the event of sequester to be overly negative. In our view, this overly negative outlook supports our Buy ratings on these stocks.

Figure 1. Mkt. implies perpetual FCF reductions based on 2013E FCF

	Zero-Growth Mkt Value ($m)	Current Mkt Value ($m)	Mkt Value Attributable to Zero Growth	Mkt-Implied Perpetual FCF Growth Rate
GD	$31,703	$23,405	135.5%	(3.2%)
LMT	$33,705	$28,250	119.3%	(1.2%)
NOC	$23,128	$15,603	148.2%	(4.1%)
RTN	$34,555	$17,734	194.9%	(6.9%)

Source: Citi Research, Bloomberg

Figure 2. FCF reduction implied w/ "sequester-adjusted" 2013E UFCF

	5% haircut	10% haircut	15% haircut	20% haircut	25% haircut	30% haircut
GD	(2.6%)	(2.0%)	(1.4%)	(0.8%)	(0.2%)	0.4%
LMT	(0.8%)	(0.4%)	0.0%	0.5%	0.9%	1.3%
NOC	(3.4%)	(2.8%)	(2.2%)	(1.5%)	(0.9%)	(0.2%)
RTN	(6.2%)	(5.4%)	(4.7%)	(4.0%)	(3.3%)	(2.5%)

Source: Citi Research, Bloomberg

What We Expect

Avoiding sequester likely involves reducing defense spending by ~$500b over 10Y…but we expect the cadence to change. The net effect is a flattish nominal base budget over 10Y.

While we expect sequester to formally trigger on March 1, we do not expect it to stick over 10Y which implies a large one-year reduction, followed by steady growth (Figure 3).

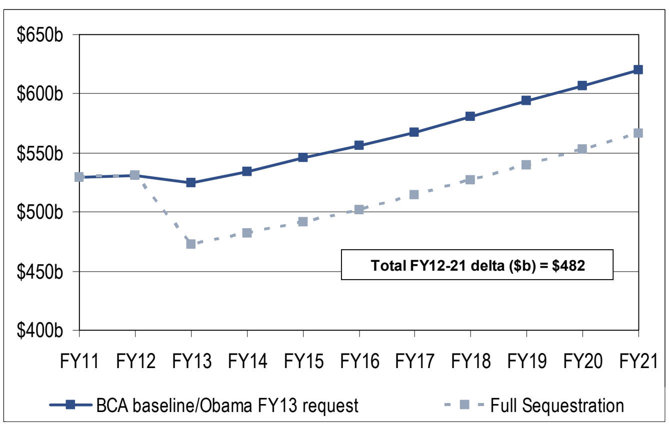
Instead, we expect an eventual deal that appreciates the fact that you can achieve the same aggregate level of spending cuts by spreading them out over several years. This *still* reduces spending by an incremental ~$480b over 10Y, but does so in a more manageable fashion by evenly spreading out the cost reductions. The net effect is a flattish nominal base budget for 10Y (Figure 4).

Our "sequester-spread" scenario is reflecting in last week's CBO numbers and this week's Democratic proposal to unwind the FY13 sequester.

We saw this idea embedded in the numbers released by the CBO last week (see: It's right in front of your nose, if you'd only just open your eyes). More importantly, we saw a mini version of the "sequester spread" contained in Thursday's sequester replacement bill proposed by the Democrats which replaced one year of defense sequester with $27.5b of reductions spread between FY15-21.

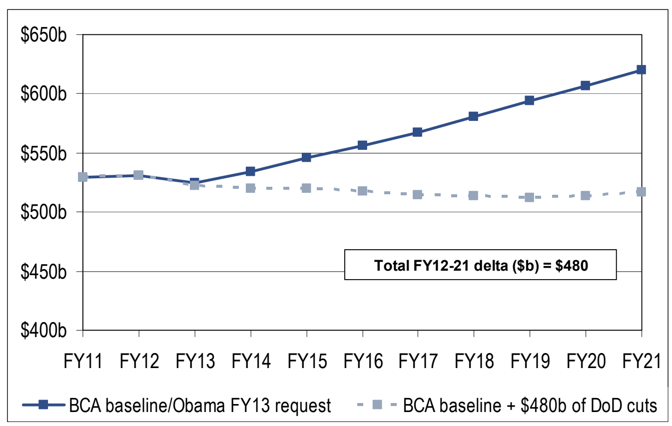
In our view, such a plan would allow the Democrats to say they protected entitlements. And it would reward the Republicans with the discretionary spending cuts they've been after. What it won't do is address entitlement or tax reform. But since neither Party appears courageous enough to make the real tough choices in the near-term, we view the re-sequenced sequester as the easiest way out. We also remind investors that this outcome would be more in line with how Washington DC typically cuts budgets: save the pain for later.

Figure 3. We don't expect: front-loaded ~$480b over 10Y (sequester)



Source: Citi Research

Figure 4. We do expect: more manageable back-loaded ~$480b



Source: Citi Research

Company Perspectives

Over the course of our two days in DC, we met with several companies. Below are our primary takeaways from the meetings.

Boeing Defense (BDS)

Boeing reiterated the view that it's misguided to think the global security environment is as safe today as it was in the post-Cold War period. Instability and geopolitical uncertainty in Asia, the Middle East, and Africa continue to drive security requirements.

Helping Boeing's international campaigns is its one company approach which leverages the commercial arm and its international relationships. The single approach also helps reduce supply cost by aggregating purchasing across the entire company. International efforts are further helped by the US government which has vastly improved its support for international defense sales over the last few years. BDS is also looking to leverage the commercial arm to pursue specialty aircraft sales to the US military which flies a few dozen old 707s. The idea would be to replace them with a new 737 which has already been militarized thanks to the P8A program.

Meanwhile, Boeing is also staying ahead of the coming drawdown, with BDS leadership beginning a cost reduction plan 2-3 years ago targeting $2.2b. Since achieving the first tranche, management is looking for an incremental $1.6b, which includes headcount and facility consolidation. Cost savings are also coming from the aforementioned aggregated purchasing efforts. With these cost reduction efforts in place, Boeing will continue to invest in high priority items and compete in the growth markets. Included here is the future vertical lift program that over the coming decades aims to replace the Blackhawk and Apache. Boeing (which makes the Apache) has teamed with UTX/Sikorsky (makes the Blackhawk) to pursue this opportunity. And despite articles to the contrary, the KC-46A is performing to plan and hitting its milestones.

Still, there are some soft spots in the portfolio, the largest of which being the C-17 with a backlog that takes it through 2014 (USAF + India). There is room for upside with incremental international orders (EU, India, Middle East), but maintaining full production might be tough. BDS' services & spares business could also encounter pressure in the nearer-term as DoD is forced to defer maintenance in government-owned depots, which could foster some migration from the contracted depots.

Lockheed Martin

If sequester occurs, the company expects a relatively limited impact on investment accounts at first given the DoD's desire to blindly cut priority programs and the increased cost associated with breaking contracts. Rather, saving money quickly involves reducing O&M costs.

As far as LMT's segments go, Space and Aero are relatively immune from sequester in FY13 since they're working through long-lived backlogs. At the other end of the spectrum is IS&GS, which likely sees the largest impact in a sequester scenario since the segment converts ~30-35% of current FY funding into current FY sales. Meanwhile, the two new segments comprising the legacy Electronics business are somewhere in between. Margin-wise, LMT expects to be able to relatively quickly reduce costs and cope with the drawdown, so the near-term sequester impact on margins should be minimal.

This is not to say that sequester will be without its victims. Budget reductions likely force new award delays, stretched programs, and quantity reductions. For instance, DoD has testified that sequester could remove 2 F35s from the planned procurement of 19 jets this year. However, we note that the outcome could change based on whether the DoD receives some leeway on how to implement the cuts (in our view, the Navy is most likely to defer or reduce F35C orders vs. the Marines or Air Force since the Navy has a readily available near-replacement in Boeing's F/A-18). At the same time, the company could manage to keep unit volumes up by bringing international customers forward.

The company maintained its initial argument behind 4Q's $2.5b discretionary pension contribution, noting that it locks in an attractive tax deduction (especially if the corporate tax rate goes down) without giving up much return from cash sitting on the balance sheet. The large contribution also reduced go-forward pension contribution requirements, although the company still plans to discretionarily fund the pension at the same level as its CAS recovery in 2013-15, noting that CAS recovery picks up even more materially thereafter and likely overwhelms pension contributions. Also, D&A is likely to grow as software amortization increases. And as previously mentioned, requirements are minimal in 2013 and 2014. Working capital likely remains a use of cash for the next few years, although things likely improve from the 2012 level which was impacted by some EVMS issues and the transition from performance-based payments to progress-based payments on some fixed-price contracts. Altogether, it appears as if the company can keep operating cash flows at least flat over the next several years (2013 guided to >/= $4b).

FCF is also set to benefit as capex comes down due to lower F35 investments and capitalized software. It appears as if LMT has spent ~$1-1.5b of capital thus far on F-35 with a total bill of just below ~$2b. Thus, within three years the company can likely get down to $700m capex (representing cash upside vs. our current estimate of $1b).

While share repurchases came in relatively light in 2012 vs. expectations, it's worth noting that a good portion of the year's share creep (6-7m shares) was attributable to stock option exercises driven by strong stock performance. As is the case every year, LMT will work again in 2013 to offset share creep with repurchases. In our view, the guided $700m of repurchases is conservative given our expectations for strong cash generation this year, and we expect it to have more impact that simply arresting share creep since the guidance contemplates 4m shares issued related to the 401k and 3m shares of options exercises. The implied $100 stock price is clearly higher than where the stock has sat YTD, and we therefore suspect there to have been higher impact repurchase activity since late January. We also note that the lower stock price minimizes option dilution for the moment. Going forward, the company does not anticipate seeing as much option-driven dilution as it has changed its executive compensation plan to grants RSUs and PSUs instead of options. However, there are still 11m options in-the-money at the moment, so there's still some option-related dilution to come.

The company is also careful with its balance sheet, which screens more levered than it appears if you include a portion of the unfunded pension liability (which 2 of the 3 rating agencies do). For that reason, the company is relatively more reluctant to lever up appreciably simply to buy back shares, preferring to maintain its credit rating and preserve dry powder should M&A opportunities appear.

The company is looking forward to several large strategic awards in 2013, which while not large in dollar-size do represent significant long-term business opportunities:

- The Aegis engineering contract is a franchise award that likely comes this quarter. LMT enjoys a ~20-25 year incumbency but faces stiff competition from RTN.
- Air & Missile Defense Radar (AMDR) represents the ballistic missile radar for nextgen destroyers and retrofit of old destroyers. It's likely awarded in 1H.
- Space fence is a long-term RTN franchise that LMT is trying to take away. It's likely awarded in 4Q13, although it could slip into 2014.

Northrop Grumman

NOC is clearly concerned with a variety of budget challenges making their way through Congress, including sequester, CR, and debt ceiling. The company appears to agree that the House GOP sees sequester as leverage in getting President Obama to the table, and that perhaps the noise caused by sequester would be enough to force Congress to get something done. But as is typical with Congress, they'll likely wait to the very last minute and kick the can. Either way, NOC is prepared to deal with sequester, a government shutdown, or a full-year CR.

As we head toward sequester, it appeared that short-cycle businesses were indeed set to be hit first, with logistics, maintenance, and IT systems likely seeing the most near-term volatility. The ultimate budget deal could breed investment account reductions, but at the moment NOC still has backlog and contracts to execute. However, in the event that contracts are broken as a result of budget reductions, the government is likely to incur the vast majority of the costs.

NOC's recent M&A activity has focused more on subtraction than addition in order to position the portfolio to be best aligned for future defense priorities. Given uncertainty and persistent disparity in pricing, it appears that NOC is happier purchasing itself vs. buying revenue growth. That said, the company has moved aggressively into unmanned and was able to pick up some small cyber companies years ago. In short, NOC isn't looking for scale as much as it's looking for value. NOC also highlighted that it prefers to stick to its core business of dealing with government customers and regulated markets (implying it's not a fan of defense companies undertaking purely commercial pursuits).

While the company is relatively aggressive with its share repurchase program (and appears open to using leverage to buy back stock), it's still weary of an uncertain environment and will not get too far ahead of the budget uncertainty. The company noted that it's typically frugal with its cash, especially in uncertain environments.

International sales are still set to growth as the company looks to supply US allies with high-end electronics and other technologies. This is especially true as the US withdraws from certain regions and relies more on its partners to provide for a stable security environment.

NOC also reiterated that its better pension funding position and lower CAS recovery rates going forward could help its competitive positioning by being able to bid a lower price as a result of a lower cost structure. We heard something similar on our bus tour from last year (see: Defending Against the Unknown).

NOC highlighted how recent management changes at the segment level have put in place new leaders with long tenures and solid understanding of the business.

Booz Allen Hamilton

Booz Allen is primarily engaged in the services industry, focusing on critical programs and projects. The company actually saw an increase in outlays in its recent quarter, perhaps due to the government's efforts to get money out of the door before budget reductions hit. Starting in April, BAH will implement a new organizational structure to better align the company with what and how clients buy. The evolved organization is also a step along the path to realizing the company's "Vision 2020" which sees Booz continuing to leverage its capabilities in core government work as well as in other growth markets including health, financial services, and energy.

However, the current environment is relatively pressured as program officers react to real and perceived program cuts. This creates short-term market turmoil, although the system generally finds a way to make reductions necessary when it's handed a certain level of cuts, while also continuing to invest in high priority items. The environment is likely to remain pressured and somewhat disorganized in the near term as the department adjusts to slowed and/or reduced spending, but eventually a new rhythm generally kicks in.

In preparation for the budget drawdown, BAH continues to actively control its costs through improved resource management, including saving on facilities through solutions such as implementing hoteling policies. The company also notes that its services business model allows it to expand margins even in the face of top-line pressure.

CACI

Services-provider CACI is on the same page as other companies with regards to the budget, considering this a unique period of great instability. On its last earnings call, the company reduced its FY13 outlook given slowed procurement behavior at DoD. The company has also talked about seeing bridges and delayed awards, which are partly a good thing for CACI as it continues to make money on its incumbent projects, but also pushes out expected funding actions. However, at this point the company has 97% of its planned FY13 revenue already under contract with over 87% of the funding fully secured.

CACI sees most risk from sequester in its "high volume" markets such as enterprise IT and logistics readiness, since the military can more easily save money here quickly by slowing things. On the other hand, CACI expects to drive growth by aggressively pursuing "high-growth" markets that include business systems, cyberspace, healthcare, and special operations. In this realm, the company is already doing ~$200m of annual business in cyber. And some recent acquisitions have helped it get into various health end-markets including FDA, CDC, and NIH.

CACI is looking to grow earnings not only via these high-growth market opportunities, but also by reducing the mix of low-margin ODCs (other direct costs) vs. higher-margin direct labor. In fact, recent organic sales reductions were driven by a reduction in ODCs largely due to Afghanistan vs. direct labor which has actually grown. The company also expects to secure some growth from M&A.

At this point, FY14 (begins July 1) is still a bit in limbo as the sequester impact is yet to be seen and as CACI's backlog generally doesn’t bleed into the following year.

Boeing Co.

(BA.N; US$74.93; 1)

Valuation

We apply a sum-of-the-parts valuation methodology to Boeing. To the commercial business (66% of 2013 segment income) we apply a 15x FTM P/E multiple, in line with commercial aerospace peers. In our view, a premium multiple is warranted due to the production up-cycle we're embarking upon as well as the relative resiliency of the commercial aerospace market. We apply a 11x multiple to the defense business, representing a ~20% discount to the market. This is a slight premium to our target defense multiple (25% discount) due to BDS' premium backlog visibility and international content. This gives us a blended target multiple of 13.6x, which we apply to our 2014 core EPS estimate to yield our $100 PT. We expect Boeing and investors to begin focusing on this pension-adjusted "core EPS" number now that Boeing has begun guiding specifically to it since it more accurately reflects underlying performance.

Risks

The commercial aerospace industry is intrinsically risky given its vulnerability to unpredictable shocks that cannot be incorporated into earnings models, such as terrorism, volatile oil prices, and epidemics. Furthermore, the industry is highly correlated to economic growth, and relies on economic expansion for air traffic growth. The company’s other exposure is the defense market, which is subject to changes in public opinion, global threats to the U.S. and its allies, the state of the federal budget, and the condition of existing U.S. and allied military equipment.

Boeing’s shares may materially underperform our target price should the broader economy slip back into recession, resulting in decreased airline traffic and plane orders. Shares would also underperform to the extent that DoD budgets were severely cut. The company is also subject to intense commercial competition with Airbus, especially in the narrow-body segment, where defending market share could come at the expense of margin. If the impact on the company from any of these factors proves to be greater/less than we anticipate, we believe the stock will likely have difficulty achieving our target price or could outperform it.

General Dynamics Corp.

(GD.N; US$66.22; 1)

Valuation

Historically, shares of GD have traded at 14x FTM P/E and at a 12% discount to the S&P500. While we concede that defense industry multiples are not likely to return to levels seen during the recent war build-up, we do argue that they should return to the levels seen during the Post-Consolidation & Stable Demand era between 1995 and 2001 – a period that best reflects the current environment, in our view. During this period, ex-the dotcom bubble, defense shares traded at a 25% discount to the S&P 500. We apply a 30% discount to the market multiple to arrive at our target defense multiple of 9.6x due to GD defense's less certain outlook.

For the company's commercial aerospace business, we apply a multiple in line with a basket of commercial aerospace companies (15x). Our blended target multiple is calculated as following:

- Defense multiple = 9.3x, applied to 66% of income
- Commercial multiple = 15x, applied to 34% of income

The result is a blended multiple of 11.4x, below the 10-yr average of 14x likely due to the premium assigned to defense during wartime. Applied to our FTM EPS estimate twelve months from now, we arrive at our price target of $86. Our price target implies a 7.2x EV/EBITDA multiple, vs. the 10-yr average of 9.5x.

Risks

GD's strengths (large capitalization, low earnings and share price volatility, investment grade balance sheet, and historically strong cash flows) are offset by the risk inherent in having ~70% of revenues tied to one customer (a fiscally pressured US government), and by being exposed to inherently risky aircraft development programs.

Risks to the upside include on-going conflicts requiring defense spending on vehicles and munitions beyond our current expectations. There may also be a sooner-than-expected broad revival in business jet demand and commercial shipbuilding.

Risks to the downside include a further deterioration of global economic environment, both of which would put pressure on government spending and negatively impact domestic and international sales (commercial and government). Defense acquisition reform could also become a negative for industry margins, although we are not overly concerned with its current iteration. Also, an end to the current conflicts may further erode the need for land-based combat systems, while strategic priorities may obviate the need for major naval platforms. Aircraft development programs can also slip schedule- and cost-wise due to unforeseen contingencies.

If the impact on the company from any of these factors proves to be greater/less than we anticipate, we believe the stock will likely have difficulty achieving our target price or could outperform it.

Lockheed Martin Corp.

(LMT.N; US$87.08; 1)

Valuation

Over the past decade, LMT shares have historically traded at 16x and roughly flat to the S&P 500. While we concede that defense industry multiples aren't returning to levels seen during the last decade, we do argue that they should return to the levels seen during similar demand environments of the past, specifically the Post-Consolidation & Stable Demand era between 1995 and 2001, a period that best reflects the current environment, in our view. During this period (ex-the dotcom bubble) defense shares traded at a 25% discount to the S&P 500 (14x). We believe LMT should trade at a mild premium (at a 20% discount to the market) due to the robust dividend, the long-term sales and earnings growth potential embedded in the F-35 program, and a robust international business. We also believe investors will increasingly use FAS / CAS adjusted EPS vs. GAAP EPS for valuation purposes in light of the December 2011 harmonization ruling , which in our view cements the adjusted numbers as the more “normalized” earnings stream for defense companies. We therefore apply our target multiple of 11x to our FTM pension-adjusted EPS estimate to arrive at our price target of $110.

Risks

Strength derived from Lockheed Martin's large capitalization, low earnings and share price volatility, investment grade balance sheet, and historically strong cash flows, are offset by the fact that 90% of its revenues are tied to a US government customer. Domestic fiscal pressures are the most prominent downside risk, as a significant reduction in government spending would negatively impact domestic and international sales. And although we do not judge its current iteration as a major threat, acquisition reform could become a negative for industry margins. Upside and downside risks also emanate from geopolitical events impacting alliance structures and cross-border relationships, which would change defense spending habits and thus impact industry multiples. The company’s marquee program, the F-35 JSF, is facing negative headlines and Congressional heat over its cost, and runs the risk of being slowed/delayed (although we do not believe the program will erode significantly due its strategic importance).

If the impact on the company from any of these factors proves to be greater/less than we anticipate, we believe the stock will likely have difficulty achieving our target price or could outperform it.

Northrop Grumman Corp.

(NOC.N; US$65.80; 1)

Valuation

Historically, NOC shares have traded at 14x FTM EPS estimates and at a 30% discount to the S&P 500. While we concede that defense industry multiples are not likely to return to levels seen during the most recent war build-up, we argue that they should return to the levels seen during the spending era that best reflects the current environment, specifically the post-consolidation, stable demand environment era between 1995 and 2001. At that time (ex-the dotcom bubble), defense shares traded at a 25% discount to the market. In our view, NOC should trade at a premium to peers given growth opportunities in manned and unmanned fighters and targeted cash returns to shareholders. We also believe investors will increasingly use FAS / CAS adjusted EPS vs. GAAP EPS for valuation purposes in light of the December 2011 harmonization ruling, which in our view cements the adjusted numbers as the more "normalized" earnings stream for defense companies. We therefore apply a target multiple of 11x (20% discount to the market) to our FTM pension-adjusted EPS estimate to arrive at our price target of $79.

Risks

Northrop's large capitalization, low earnings and share price volatility, investment grade balance sheet, and historically strong cash flows, are offset by the fact that ~91% of its revenues are tied to one customer: the US government (mostly the Defense Department). Risks to the downside include a further deterioration of global economic environment and the domestic fiscal situation, both of which would put pressure on government spending and trading multiples. And although we do not judge its current iteration as a major threat, acquisition reform and pentagon-led efficiency drives could become a negative for industry margins. Also, strategic priorities may reduce the need for major platforms, including the F-35 JSF which faces negative headlines and congressional heat over its cost (although we expect NOC to be able to offset some of the weakness with its F/A-18 content). Further downside risks emanate from geopolitical events which could impact defense spending habits and industry multiples.

If the impact on the company from any of these factors proves to be greater/less than we anticipate, the stock could have difficulty achieving our target price/outperform it.

Appendix A-1

Analyst Certification

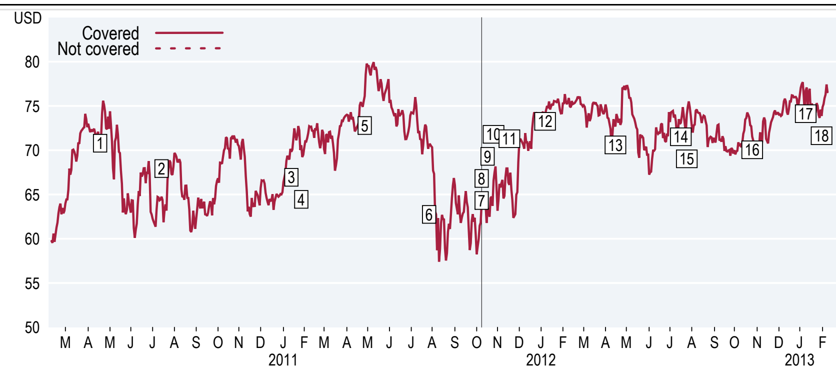
The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

Boeing Co. (BA)

Ratings and Target Price History
Fundamental Research

Analyst: Jason Gursky
Covered since July 15 2010



	Date	Rating	Target Price	Closing Price
1	19-Apr-10	2H	*73.00	70.96
2	14-Jul-10	*1H	*80.00	64.75
3	13-Jan-11	1H	*85.00	69.83
4	27-Jan-11	1H	*84.00	70.56
5	27-Apr-11	1H	*90.00	76.12
6	27-Jul-11	1H	*85.00	70.63
7	8-Oct-11	Stock rating system changed		
8	8-Oct-11	*1	85.00	61.81
9	18-Oct-11	1	*87.00	63.47
10	26-Oct-11	1	*78.00	66.56
11	17-Nov-11	1	*82.00	66.09
12	6-Jan-12	1	*87.00	73.98
13	16-Apr-12	1	*89.00	72.68
14	17-Jul-12	1	*93.00	73.11
15	25-Jul-12	1	*89.00	74.03
16	25-Oct-12	1	*84.00	71.54
17	9-Jan-13	1	*104.00	76.76
18	31-Jan-13	1	*100.00	73.87

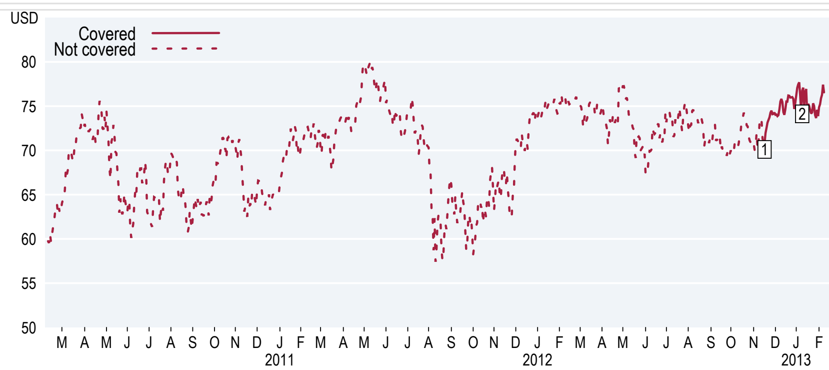
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Boeing Co. (BA)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Jason Gursky
Covered since July 15 2010



	Date	Rating	Target Price	Closing Price
1	16-Nov-12	*ADD MP	-	70.77
2	9-Jan-13	*REM MP	-	76.76

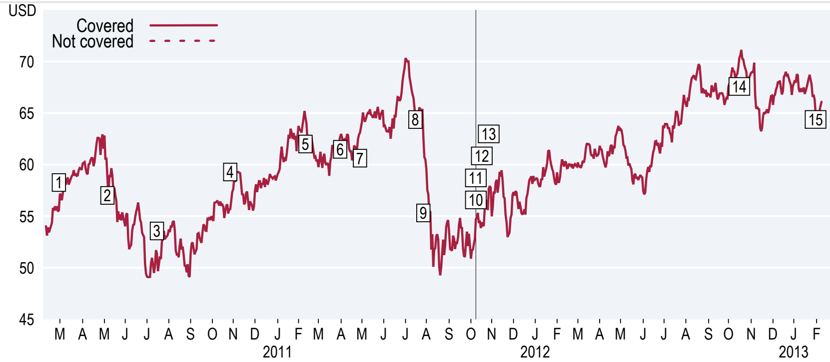
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Northrop Grumman Corp. (NOC)

Ratings and Target Price History
Fundamental Research

Analyst: Jason Gursky
Covered since July 15 2010



	Date	Rating	Target Price	Closing Price
1	26-Feb-10	2M	*56.25	55.57
2	6-May-10	2M	*62.60	58.67
3	15-Jul-10	*1H	62.60	51.36
4	27-Oct-10	1H	*66.22	55.68
5	10-Feb-11	1H	*77.11	64.55
6	31-Mar-11	1H	*76.00	62.71
7	28-Apr-11	1H	*79.00	63.09
8	15-Jul-11	1H	*83.00	64.62
9	27-Jul-11	1H	*80.00	62.68
10	8-Oct-11	Stock rating system changed		
11	8-Oct-11	*1	80.00	52.81
12	18-Oct-11	1	*71.00	54.40
13	27-Oct-11	1	*69.00	57.64
14	16-Oct-12	1	*78.00	70.36
15	31-Jan-13	1	*79.00	65.04

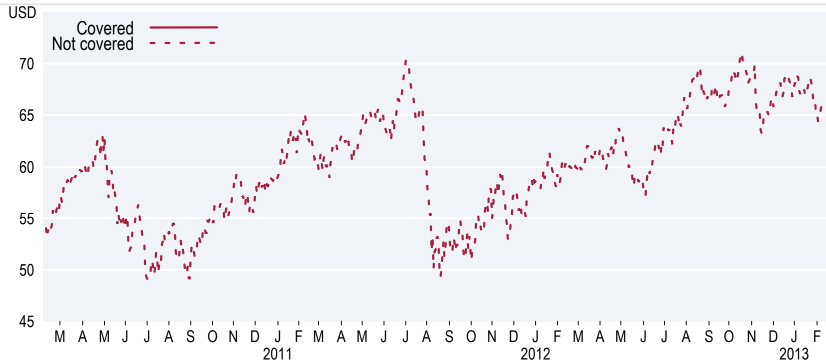
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Northrop Grumman Corp. (NOC)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Jason Gursky
Covered since July 15 2010



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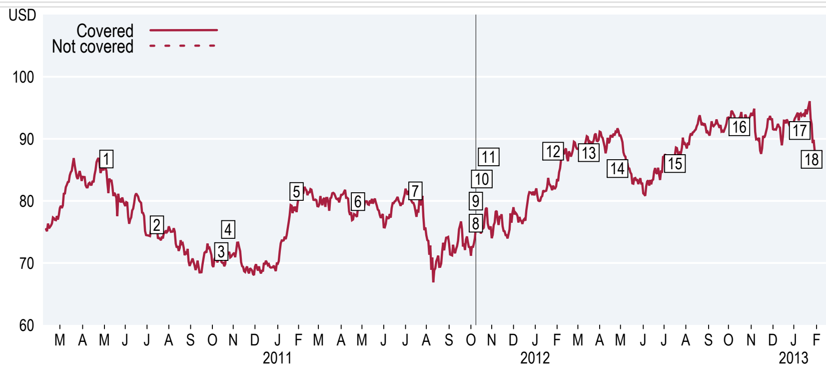
Rating/target price changes above reflect Eastern Standard Time

Lockheed Martin Corp. (LMT)

Ratings and Target Price History
Fundamental Research

Analyst: Jason Gursky
Covered since July 15 2010



	Date	Rating	Target Price	Closing Price
1	5-May-10	1M	*95.00	84.84
2	15-Jul-10	*1H	*97.00	75.95
3	14-Oct-10	1H	*91.00	70.20
4	24-Oct-10	1H	*88.00	71.78
5	28-Jan-11	1H	*100.00	78.20
6	26-Apr-11	1H	*104.00	79.04
7	15-Jul-11	1H	*102.00	78.37
8	8-Oct-11	Stock rating system changed		
9	8-Oct-11	*1	102.00	74.00
10	18-Oct-11	1	*92.00	75.98
11	27-Oct-11	1	*89.00	75.65
12	26-Jan-12	1	*92.00	82.47
13	16-Mar-12	1	*108.00	89.32
14	26-Apr-12	1	*105.00	91.70
15	17-Jul-12	1	*103.00	87.43
16	16-Oct-12	1	*108.00	93.37
17	9-Jan-13	1	*106.00	93.99
18	25-Jan-13	1	*110.00	92.39

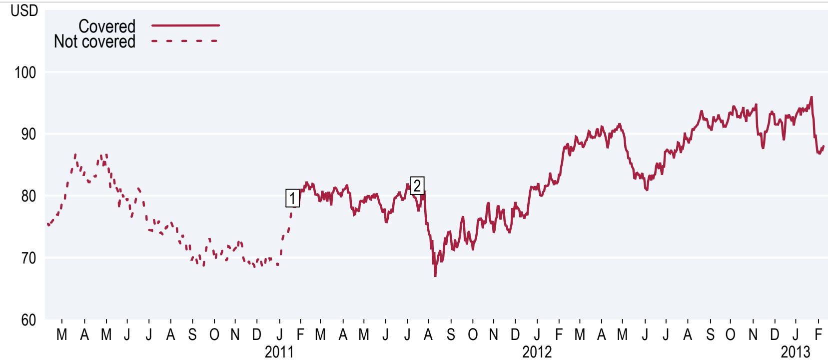
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Lockheed Martin Corp. (LMT)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Jason Gursky
Covered since July 15 2010



	Date	Rating	Target Price	Closing Price
1	20-Jan-11	*ADD MP	-	79.32
2	15-Jul-11	*REM MP	-	78.37

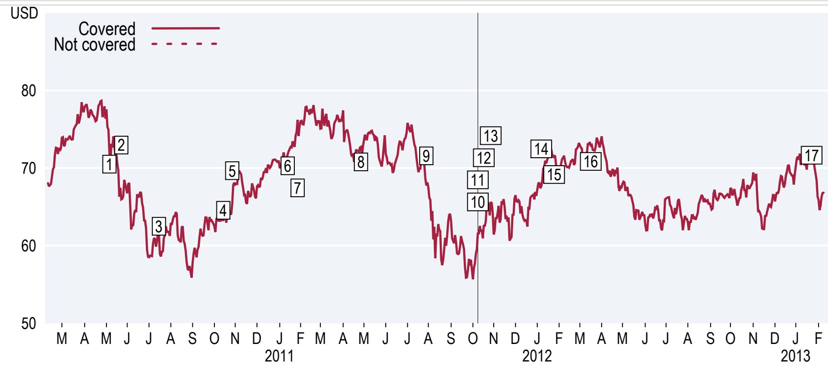
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

General Dynamics Corp. (GD)

Ratings and Target Price History
Fundamental Research

Analyst: Jason Gursky
Covered since July 15 2010



	Date	Rating	Target Price	Closing Price
1	6-May-10	3M	*67.00	72.06
2	24-May-10	*2M	67.00	65.96
3	15-Jul-10	*2H	*69.00	61.47
4	14-Oct-10	2H	*71.00	63.17
5	27-Oct-10	2H	*75.00	65.42
6	13-Jan-11	*1H	*87.00	71.78
7	27-Jan-11	1H	*88.00	76.20
8	27-Apr-11	1H	*91.00	72.72
9	28-Jul-11	1H	*90.00	67.75
10	8-Oct-11	Stock rating system changed		
11	8-Oct-11	*1	90.00	59.55
12	18-Oct-11	1	*86.00	62.64
13	27-Oct-11	1	*87.00	65.61
14	6-Jan-12	1	*88.00	67.62
15	25-Jan-12	1	*85.00	71.57
16	16-Mar-12	1	*88.00	72.90
17	23-Jan-13	1	*86.00	71.45

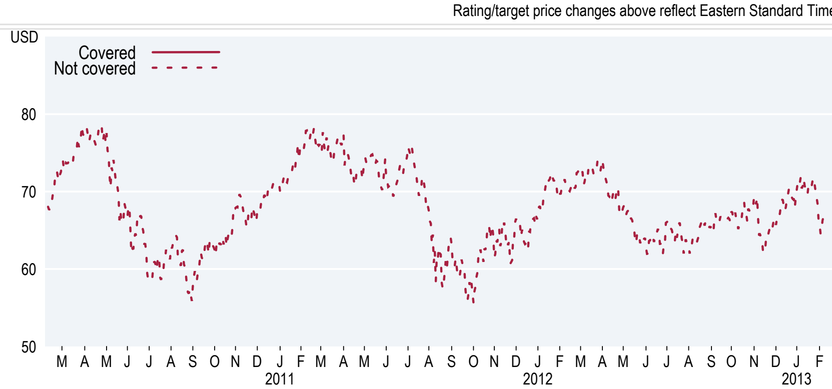
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

General Dynamics Corp. (GD)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Jason Gursky
Covered since July 15 2010



* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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