

# Huntington Ingalls Industries (HII)

## Alert: 2Q Margins & Backlog Expand; Remain Overweight

**Citi's Take** – Huntington Ingalls reported 2Q results slightly ahead of our expectations with 70bp margin improvement on a 2% reduction in top-line. Despite ongoing budget uncertainties and the lumpy nature of defense contracts, we continue with our Overweight (OW) on HII owing to solid backlog (3x annual revenues), long build cycles, and expectations for continued margin improvement.

**The Numbers** – HII reported 2Q revenues of \$1.68bn (-2.2% y-o-y), in-line with expectations in the range of \$1.65bn. Quarterly EBITDA equated to \$160mm (vs. \$151mm in the prior year period), a slight beat compared to our and Street projections of ~\$150mm. Segment operating income margin increased 70bp y-o-y to 8.1%. Improved operating performance at Ingalls and risk retirement at Newport News drove the margin expansion. Total backlog of \$20.7bn was up 20.3% sequentially (representing ~3x annual revenues). On the call, management reiterated its goal of 9%+ operating margins by 2015.

**Segment Recap** – Ingalls segment (40% of 2Q sales): revenues declined 11.1% y-o-y due to lower sales on amphibious assault ships. Segment operating income margin expanded ~20bp y-o-y to 5.2% owing to the risk retirement on amphibious assault ships and NCS program. Newport News segment (60% of 2Q sales): revenues increased 5.3% y-o-y due to higher sales on fleet support, submarines and aircraft carriers. Segment operating income margin expanded ~70bp to 9.8% owing to VCS program risk retirement and performance improvements.

**FCF & Balance Sheet** – The Company reported neutral cash flow for the quarter owing to discretionary qualified pension contributions (completing the planned contributions for the year). Due to timing of receipts and ship deliveries, FCF for 2013 is expected to be weighted towards 2H (similar to FY12). As of Jun 30, HII had cash and equivalents of \$623mm and its \$650mm revolver due 2016 was undrawn. Gross and net leverage was 2.8x and 1.6x, respectively.

**Credit Implications** – We continue with Buy (1) ratings on HII 6.875% and 7.125% senior notes, despite recent outperformance vs. the BB-rated Index (measured on YTD basis). The 7.125% notes due 2021 currently yield 4.80%.

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## Appendix A-1

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Huntington Ingalls Industries Inc (HII) — Issuer Portfolio Weighting and Issue Rating History

High Yield Credit Research

Analyst: Manish A. Somaiya

Issuer		Issue			
Weighting	Date	Coupon	Description	Maturity	Date
OW	05-Oct-12	6.875%	Sr Nts	15-Mar-18	Buy (1)
		7.125%	Sr Nts	15-Mar-21	Buy (1)

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