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Aerospace & Defense (Citi)
North America

Fiscal Cliff Update

- Industry Overview

Alert: Our Base Case & Constructive Outlook Remain Intact

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- **What's New** – Congress and the President avoided a leap off the fiscal cliff this week in reaching an agreement to avert the majority of tax hikes that would have occurred without action. However, they punted needed decisions on the spending side of the "Fiscal Cliff" for two months – which led to most defense stocks underperforming the broader market today given continued uncertainty in the DoD's budget outlook.

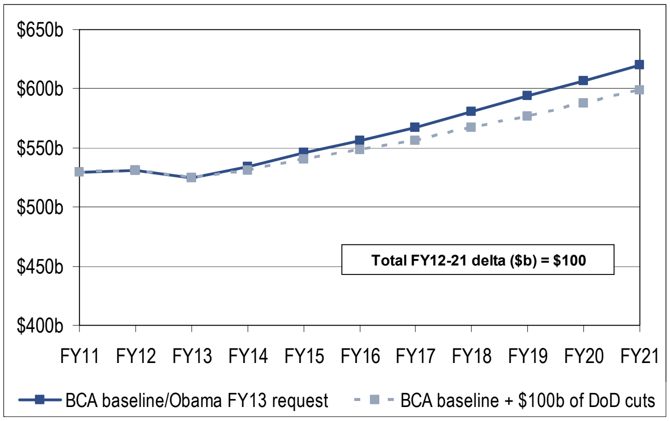
- **Our Base Case Budget Outlook Remains Intact –** We continue to expect a flat 10-year budget outlook for DoD once the dust settles later this year. Our contention has long been that DoD will indeed face further cuts – perhaps as high as the $500B contemplated in sequester – but that the cadence of the cuts would change and be pushed toward the back end of the ten year budget outlook. Such an outcome would allow DoD to better manage the cuts and it would also better reflect traditional DC budget cutting exercises. Finally, it would also translate into a flattish revenue outlook for most defense companies – which is more robust than what is currently priced into stocks.

- **Constructive Outlook for Stocks Also Remains Intact -** With stocks pricing in 2-4% perpetual declines in FCF, we still see opportunity in owning defense names thanks to our outlook for flattish sales, resilient margins, and attractive cash flow generation supporting 8-12% cash returns based on repurchases & dividends. See Figure 3 below and our recently published Fiscal Cliff Update Post-Election note for more details.

- **Potential Upside to Our Base Case Still Looks Possible** – Despite the lack of action this week on garnering a final spending deal, it is noteworthy that at no time during the recent negotiations did reports surface of a GOP proposal calling for incremental defense cuts. In fact, the most the White House proposed was $100b over 10Y (incremental to the $490b that was part of the FY13 budget proposal in February). Either way, both parties are proposing incremental cuts that are lower than our estimate of $500b spread evenly over 10Y, which would flat-line DoD budgets for a decade. To that extent, it looks like a potential budget deal later this year would largely spare DoD budgets and come in better than our current forecast – which of course would be even more supportive of our constructive stance on defense stocks.

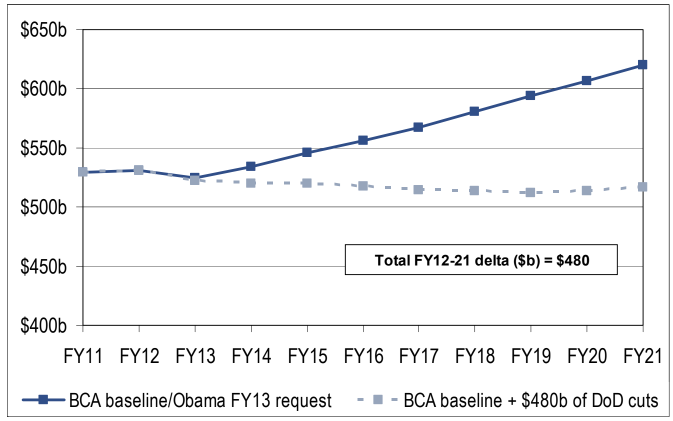
The White House proposal implies higher defense budget growth over 10Y vs. our outlook of a flat budget. There's still a good chance when we we're sitting in 2021, the preceding decade's budgets will appear flatter than what the White House has proposed. But we note that budgets are subject to a host of unknowns that drive them in one direction or another.

Figure 1. White House proposes $100b of cuts over 10Y = 1.3% growth



Source: Citi Research

Figure 2. Citi estimates $500b of cuts over 10Y = no growth



Source: Citi Research

At this point, we estimate defense stocks are still pricing in perpetual declines in free cash flow despite the fact that investment account budgets increase over the long-run and our view the defense companies will be able to maintain resilient sales, margins, and most importantly cash flow.

Figure 3. Market is pricing in perpetual FCF declines for the defense primes

	Zero-Growth Mkt Value ($m)	Current Mkt Value ($m)	Mkt Value Attributable to Zero Growth	Mkt-Implied Perpetual FCF Growth Rate
GD	$30,192	$24,365	123.9%	(2.0%)
LMT	$46,306	$30,071	154.0%	(3.4%)
NOC	$25,747	$16,815	153.1%	(4.3%)
RTN	$28,799	$19,429	148.2%	(3.5%)

Source: Citi Research

General Dynamics Corp.

(GD.N; US$71.21; 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 9.3x 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 ~69% of income

– Commercial multiple = 15x, applied to ~31% of income

The result is a blended multiple of 11.1x, 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 $88. On an EV/EBITDA basis, our price target implies a 6.7x 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$93.27; 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 10.6x to our FTM pension-adjusted EPS estimate to arrive at our price target of $108.

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$68.17; 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 & 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 10.6x to our FTM pension-adjusted EPS estimate to arrive at our price target of $78.

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.

Raytheon Co.

(RTN.N; US$58.62; 1)

Valuation

Historically, shares of RTN have traded at 14x and at a 20% 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 do argue that they should return to the levels seen during the post-consolidation, stable demand environment era between (1995-2001), a period that best reflects the current environment. During this period (ex-the dotcom bubble) defense shares traded at a 25% discount to the market. We believe that RTN should trade at a premium (a 20% discount) due to its diversified portfolio, its higher margin profile, and its industry-leading international exposure. 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 10.6x to our FTM pension-adjusted EPS estimate to arrive at our price target of $69.

Risks

RTN's large capitalization, earnings and share price volatility, investment grade balance sheet, and historically strong cash flows are offset by ~88% of its revenues being tied to one customer: the US government, and primarily 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 could become a

negative for industry margins. Meanwhile, both upside and downside risks emanate from geopolitical events which would change 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, we believe the stock will likely have difficulty achieving our target price or could outperform it.

Appendix A-1

Analyst Certification

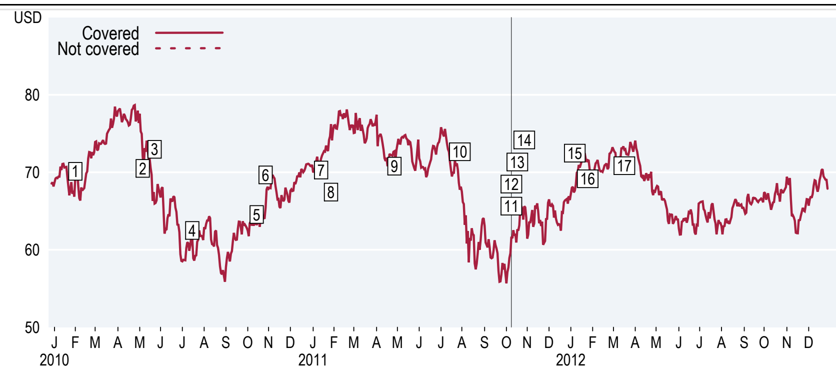
The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each 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

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	1-Feb-10	3M	*63.00	69.43
2	6-May-10	3M	*67.00	72.06
3	24-May-10	*2M	67.00	65.96
4	15-Jul-10	*2H	*69.00	61.47
5	14-Oct-10	2H	*71.00	63.17
6	27-Oct-10	2H	*75.00	65.42

	Date	Rating	Target Price	Closing Price
7	13-Jan-11	*1H	*87.00	71.78
8	27-Jan-11	1H	*88.00	76.20
9	27-Apr-11	1H	*91.00	72.72
10	28-Jul-11	1H	*90.00	67.75
11	8-Oct-11	Stock rating system changed		
12	8-Oct-11	*1	90.00	59.55

	Date	Rating	Target Price	Closing Price
13	18-Oct-11	1	*86.00	62.64
14	27-Oct-11	1	*87.00	65.61
15	6-Jan-12	1	*88.00	67.62
16	25-Jan-12	1	*85.00	71.57
17	16-Mar-12	1	*88.00	72.90

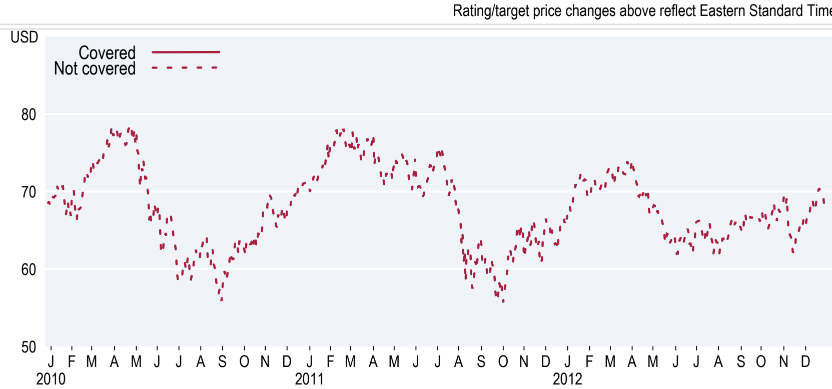
* Indicates change

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



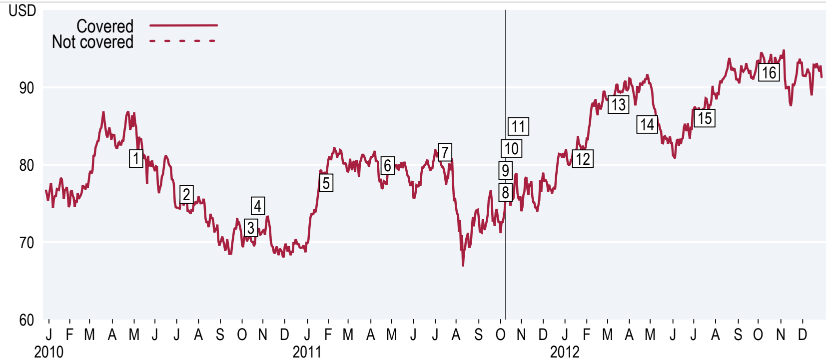
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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

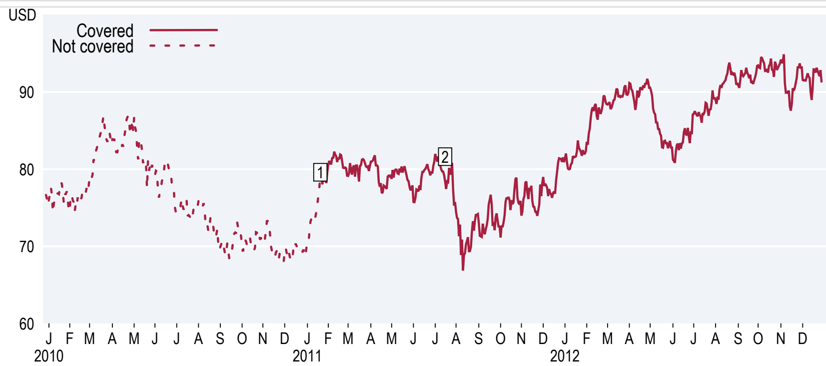
* Indicates change

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

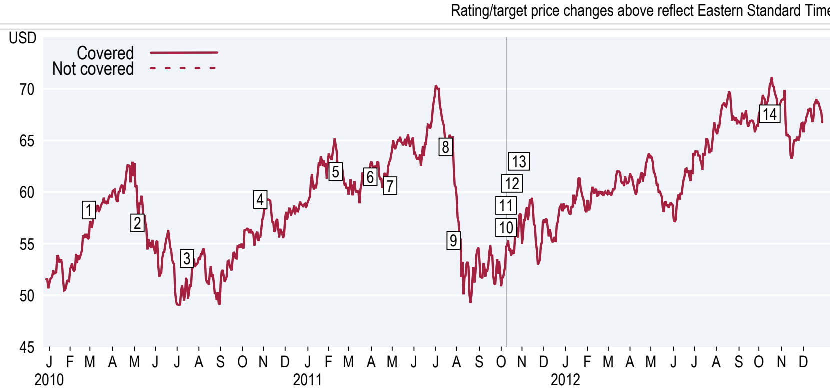
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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

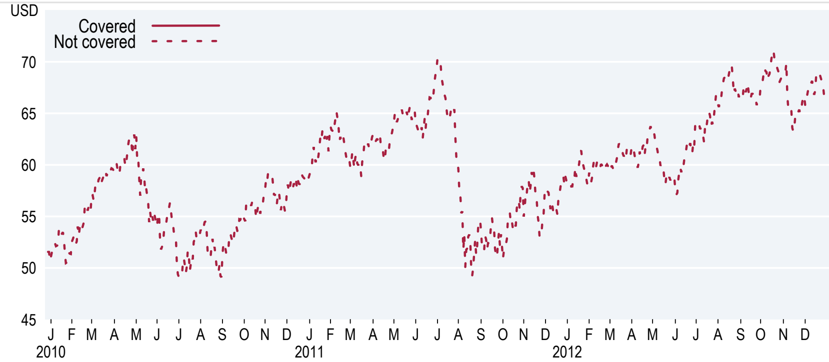
* Indicates change

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



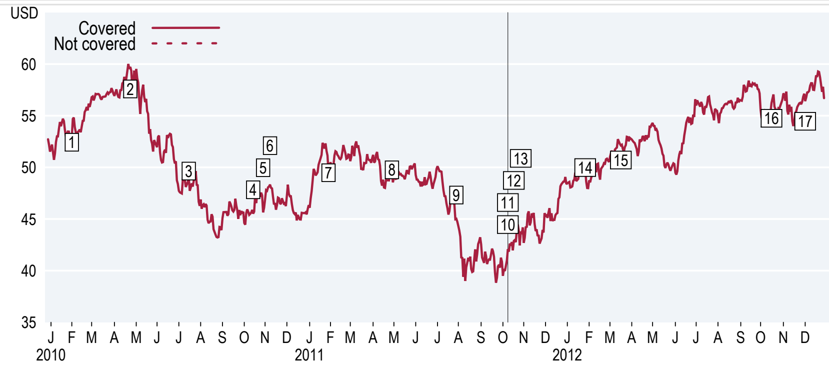
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Raytheon Co. (RTN)

Ratings and Target Price History
Fundamental Research

Analyst: Jason Gursky
Covered since July 15 2010



	Date	Rating	Target Price	Closing Price
1	1-Feb-10	2M	*57.00	52.96
2	23-Apr-10	2M	*61.00	59.72
3	15-Jul-10	*1H	*60.00	49.02
4	14-Oct-10	1H	*58.00	45.52
5	28-Oct-10	1H	*56.00	45.64
6	8-Nov-10	1H	*58.00	48.33
7	28-Jan-11	1H	*62.00	49.48
8	28-Apr-11	1H	*64.00	49.25
9	28-Jul-11	1H	*62.00	45.02
10	8-Oct-11	Stock rating system changed		
11	8-Oct-11	*1	62.00	41.00
12	18-Oct-11	1	*59.00	42.88
13	27-Oct-11	1	*56.00	43.79
14	26-Jan-12	1	*59.00	49.89
15	16-Mar-12	1	*64.00	52.12
16	16-Oct-12	1	*68.00	56.23
17	3-Dec-12	1	*69.00	56.41

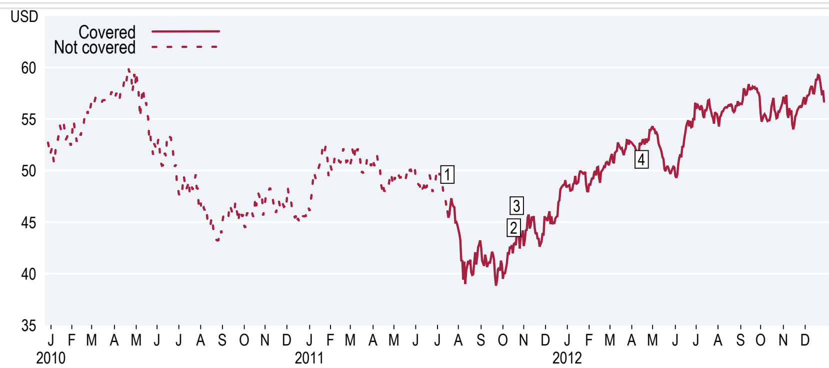
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Raytheon Co. (RTN)

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	15-Jul-11	*ADD MP	-	46.05
2	18-Oct-11	*REM MP	-	42.88
3	21-Oct-11	*ADD MP	-	43.97
4	16-Apr-12	*REM MP	-	52.60

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Citigroup Global Markets Inc. owns a position of 1 million USD or more in the debt securities of General Dynamics Corp

Citigroup Global Markets Inc. owns a position of 1 million USD or more in the debt securities of Lockheed Martin Corp

An employee of Citi serves on the board of Raytheon Co.

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Citigroup Global Markets Inc. or its affiliates has received compensation for investment banking services provided within the past 12 months from General Dynamics Corp., Lockheed Martin Corp., Northrop Grumman Corp., Raytheon Co..

Citigroup Global Markets Inc. or its affiliates expects to receive or intends to seek, within the next three months, compensation for investment banking services from Raytheon Co..

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Citigroup Global Markets Inc. currently has, or had within the past 12 months, the following as clients, and the services provided were non-investment-banking, non-securities-related: General Dynamics Corp., Lockheed Martin Corp., Northrop Grumman Corp., Raytheon Co..

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Citi Research Equity Ratings Distribution

	12 Month Rating			*Relative Rating*		
Data current as of 31 Dec 2012	**Buy**	**Hold**	**Sell**	**Buy**	**Hold**	**Sell**
Citi Research Global Fundamental Coverage	49%	38%	12%	7%	86%	7%
% of companies in each rating category that are investment banking clients	53%	49%	45%	60%	49%	55%

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Citi Research stock recommendations include an investment rating and an optional risk rating to highlight high risk stocks.

Risk rating takes into account both price volatility and fundamental criteria. Stocks will either have no risk rating or a High risk rating assigned.

Investment Ratings: Citi Research investment ratings are Buy, Neutral and Sell. Our ratings are a function of analyst expectations of expected total return ("ETR") and risk. ETR is the sum of the forecast price appreciation (or depreciation) plus the dividend yield for a stock within the next 12 months. The Investment rating definitions are: Buy (1) ETR of 15% or more or 25% or more for High risk stocks; and Sell (3) for negative ETR. Any covered stock not assigned a Buy or a Sell is a Neutral (2). For stocks rated Neutral (2), if an analyst believes that there are insufficient valuation drivers and/or investment catalysts to derive a positive or negative investment view, they may elect with the approval of Citi Research management not to assign a target price and, thus, not derive an ETR. Analysts may place covered stocks "Under Review" in response to exceptional circumstances (e.g. lack of information critical to the analyst's thesis) affecting the company and / or trading in the company's securities (e.g. trading suspension). As soon as practically possible, the analyst will publish a note re-establishing a rating and investment thesis. To satisfy regulatory requirements, we correspond Under Review and Neutral to Hold in our ratings distribution table for our 12-month fundamental rating system. However, we reiterate that we do not consider Under Review to be a recommendation.

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