Tastes a Bit Gamey

Budget Better Than Expected as DoD Fixes for Funding Game

■ Industry Overview

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- **Still Constructive on Defense** — Coming out of yesterday's FY14 budget release, we're still constructive on defense as the President's request came in better than expected & supports our outlook for resilient sales & margins for the industry. Most importantly, it appears as if DoD is ready to play the ultimate budget game of filling in missing sequester funds with emergency budgets. This is a positive sign for the industry as it lessens the blow of required reductions if there's no broad budget agreement in DC. Also, the positive mix-shift from R&D to procurement within the budget supports our expectation of resilient defense margins.

- **Stock Call** — Defense stocks outperformed the market by an avg. of 150 bps in the month following the previous 4 budget submissions. This instance shouldn't be different given positive dynamics in this proposal. But with earnings only 2 weeks away & top-line guidance reductions likely, the market may prefer a wait-and-see approach. Our favorite defense names are RTN & LMT based on resilient portfolios that fared well in the FY14 request, while continued pressure on Buy-rated NOC's Global Hawk program may distract in the near-term from its leading margins & focused portfolio. HII also fared well as DoD re-asserted its Naval priorities & a steady shipbuilding plan.

- **Budget Details** — The base budget request of $526.6b (up 0.2% y/y) is in line with our expectations. Notably, DoD left an $88b placeholder for this year's OCO budget (which won't be submitted for another month), double last year's projection of $44b. We suspect this is where DoD could seek to offset sequester cuts since emergency funds are exempt from the cap. The 5Y outlook (FYDP) reflects 2% annual growth in the base budget which is flat with the previous outlook. However, the investment account is set to outgrow the base by 100 bps over the FYDP. This budget also should reflect heightened FAS/CAS pension costs that contracts should start recovering in 2014.

- **Mix-Shifts** — The proposal makes ~$150b of back-loaded cuts through FY23 vs. sequester which requires ~$500b of font-loaded cuts. Investment accounts shoulder more of the near-term reductions, but the burden should shift to non-weapons accounts over time. However, this shift does rely on DoD winning tough political battles on healthcare & base closures. Meanwhile, the continued shift toward procurement & away from R&D bodes well for margins.

- **Fly/Float/Crawl** — The budget continues to shift toward things that fly & float, especially in the investment accounts where a 1.4% y/y decline was driven primarily by a 5% y/y reduction in Army investment offset by a 1% decline in Navy (would be flat if not for Congress adding funds to FY13) & a 2% increase in Air Force.

- **Next Steps** — Early/mid May: OCO submission. May 26: Services submit sequester spending plans for FY13. By June 1: Strategic Review is due. Next few months: Budget negotiations between Congress & White House to neutralize sequester.

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Budget Trends Review

The FY14 budget continues the FY13 budget and offers relatively little in terms of programmatic fireworks. Of note is that DoD is holding back its OCO budget for another month. In our view, it looks like DoD is readying to use OCO to offset some sequester if necessary.

The FY14 budget is largely a continuation of the FY13 request as it reflects a similar strategy and directionality in each Service, without making particularly material reductions. Whereas the FY13 budget had to cut $260b from the five-year FYDP period to fall in line with the Budget Control Act, FY14 only cuts $35b and maintains many of the investments highlight last year including long-range bomber, F-35, new tanker, and shipbuilding.

OCO budget game

DoD only submitted a base budget yesterday since it claimed that its OCO emergency budget was not ready yet. It published an $88b placeholder for the budget that should be submitted to Congress in about a month. This large placeholder is flat to last year's OCO and is double last year's FY14 placeholder. We note that this extra ~$40b that DoD could ask for in the OCO is essentially the same amount that sequester would cut from the FY13 budget. In our view, this stalling tactic is a way for DoD to prepare the flexibility it might want if Congress/White House can't strike a budget deal and sequester goes into effect for all of FY13.

Base budget moves support fly/float/crawl theory

DoD is still looking to move spending from the tail to the tooth, while the Navy & Air Force generally outperform Army in the weapons-spending category.

The FY14 request for $526.6b was roughly flat to both the enacted FY13 amount and the FY13 request made last February. The investment account was down 1.4% y/y, underperforming O&M which was flat. We see that since FY10, the base budget is relatively unchanged on a nominal basis while investment account is down amidst rising O&M costs. Ongoing reform efforts are designed to reverse this trend to preserve the "tooth" at the expense of the "tail."

Figure 1. FY14 Base Budget Request Summary by Title & by Service (Current $)

Title	FY10 Actual	FY11 Actual	FY12 Enacted	FY13 Request	FY13 Enacted	FY14 Request	% Change (FY13-14)
Procurement	$103.2	$102.1	$104.5	$98.8	$99.8	$99.3	(0.5%)
RDT&E	79.3	75.3	71.4	69.4	69.4	67.5	(2.7%)
Subtotal: Inv. Account	**$182.5**	**$177.4**	**$175.9**	**$168.2**	**$169.2**	**$166.8**	**(1.4%)**
O&M (ex-DHP)	154.7	162.7	164.7	176.3	177.4	176.3	(0.6%)
Defense Health (DHP)	29.2	31.4	32.5	32.5	32.7	33.1	1.2%
Subtotal: O&M	**$183.9**	**$194.1**	**$197.2**	**$208.8**	**$210.1**	**$209.4**	**(0.3%)**
Military Personnel	135.7	137.8	141.8	135.1	135.4	137.1	1.2%
MilCons	20.5	14.8	11.4	9.6	8.9	9.5	5.9%
Family Housing	2.3	1.8	1.7	1.7	1.6	1.5	(6.4%)
Other	3.1	2.4	2.6	2.1	2.2	2.3	3.0%
Total Base	**$528.0**	**$528.3**	**$530.6**	**$525.5**	**$527.5**	**$526.6**	(0.2%)
Component	**FY10 Actual**	**FY11 Actual**	**FY12 Enacted**	**FY13 Request**	**FY13 Enacted**	**FY14 Request**	**% Change (FY13-14)**
Army	$138.8	$136.2	$133.9	$134.6	$131.9	$129.7	(1.7%)
Navy	155.3	156.0	156.8	155.9	158.9	155.8	(2.0%)
Air Force	142.4	145.4	144.9	140.1	139.8	144.4	3.3%
Defense-Wide	91.5	90.7	95.0	94.9	96.9	96.8	(0.2%)
Total Base	**$528.0**	**$528.3**	**$530.6**	**$525.5**	**$527.5**	**$526.6**	**(0.2%)**

Source: Citi Research, DoD

The 1.4% y/y drop in the investment account was driven largely by a 5% y/y drop in Army and a 5.6% drop in Defense-wide investment accounts. Navy investments were down 1% y/y but would have been flat had Congress not added to the FY13 request. Meanwhile, Air Force investment was up 1.6% (see Figure 2, Figure 3, Figure 4). The Army underperformance is in line with our view that in this drawdown we expect things that fly & float to outperform things that crawl in the ground. As the Army troughs out, we expect fly/float investment to drive the investment accounts as new large procurement programs pick up including JSF, carrier construction, submarines, tanker, and bomber. For this reason, we prefer defense companies with relatively more Navy and Air Force exposure at this point in the drawdown since we see more downward pressure on Army budgets and headcount given the nation's strategic emphasis on Asia-Pacific where Naval/Aviation capabilities play a larger role than ground forces.

Figure 2. Army Base Budget

Army ($b)	FY12 Enacted	FY13 Request	FY13 Enacted	FY14 Request	% Change (FY13-14)
MilPers	60.1	56.4	56.2	56.6	0.7%
O&M	40.9	47.2	46.0	45.5	(1.1%)
Procurement	19.6	18.3	17.7	17.0	(4.0%)
R&D	8.4	8.9	8.6	8.0	(7.3%)
MilCons	4.2	3.2	2.8	1.9	(30.3%)
Family Housing	0.7	0.5	0.5	0.6	4.3%
R&M	0.1	0.1	0.1	0.0	(58.0%)
Total Base	**133.9**	**134.6**	**131.9**	**129.7**	**(1.7%)**
Note: Inv Acct	28.0	27.2	26.4	25.0	(5.1%)

Source: Citi Research, DoD

Figure 3. Navy Base Budget

Navy ($b)	FY12 Enacted	FY13 Request	FY13 Enacted	FY14 Request	% Change (FY13-14)
MilPers	46.3	44.2	44.4	45.4	2.3%
O&M	45.5	49.4	51.8	48.0	(7.4%)
Procurement	43.5	42.4	43.3	43.4	0.3%
R&D	17.7	16.9	16.7	16.0	(4.3%)
MilCons	2.3	1.9	1.6	1.9	17.6%
Family Housing	0.5	0.5	0.5	0.5	(3.4%)
R&M	1.1	0.6	0.7	0.7	4.8%
Total Base	**156.8**	**155.9**	**158.9**	**155.8**	**(2.0%)**
Note: Inv Acct	61.2	59.3	60.0	59.3	(1.0%)

Source: Citi Research, DoD

Figure 4. Air Force Base Budget

Air Force ($b)	FY12 Enacted	FY13 Request	FY13 Enacted	FY14 Request	% Change (FY13-14)
MilPers	35.4	34.5	34.8	35.0	0.8%
O&M	44.9	45.1	45.0	47.4	5.5%
Procurement	36.4	33.8	33.8	34.3	1.5%
R&D	26.2	25.4	25.2	25.7	1.8%
MilCons	1.5	0.6	0.4	1.4	285.8%
Family Housing	0.5	0.6	0.6	0.5	(20.0%)
R&M	0.1	0.0	0.0	0.1	36.0%
Total Base	**144.9**	**140.1**	**139.8**	**144.4**	**3.3%**
Note: Inv Acct	62.6	59.2	59.0	60.0	1.6%

Source: Citi Research, DoD

Figure 5. Defense-wide Base Budget

Other ($b)	FY12 Enacted	FY13 Request	FY13 Enacted	FY14 Request	% Change (FY13-14)
MilPers	0.0	0.0	0.0	0.0	NA
O&M	65.9	67.0	67.3	68.5	1.8%
Procurement	5.1	4.4	5.1	4.7	(8.6%)
R&D	19.1	18.2	18.8	17.9	(5.2%)
MilCons	3.5	3.9	4.2	4.2	0.3%
Family Housing	0.1	0.1	0.1	0.1	6.8%
R&M	1.4	1.4	1.4	1.5	3.6%
Total Base	**95.0**	**94.9**	**96.9**	**96.8**	**(0.2%)**
Note: Inv Acct	24.2	22.5	23.9	22.5	(5.9%)

Source: Citi Research, DoD

Slowing growth rate & back-loading the cuts

DoD is looking to save $35b over the next 5Y and ~$150b over the next 10Y by slowing growth as opposed to making outright y/y reductions.

Once again, DoD is saving money by slowing the budget growth rate as opposed to making outright y/y cuts. The FY14 budget claims to make ~$150b of cuts over the 10Y period, although vs. the BCA's 10Y period (FY13-22) the savings are closer to $120b. DoD achieves this largely by slowing the expected rate of growth over that period by ~56 bps. Over the five-year FYDP, the savings are only ~$35b compared to last year's FY13 proposal which cut $260b. This is achieved by slowing the growth rate by only 14 bps. In the FYDP, investment account growth actually increases 41 bps vs. operations/maintenance (O&M) growth which falls 60 bps. For FY13-22, investment account growth falls 47 bps vs. O&M falling 124 bps. See Figure 6, Figure 7, Figure 8, Figure 9, Figure 10.

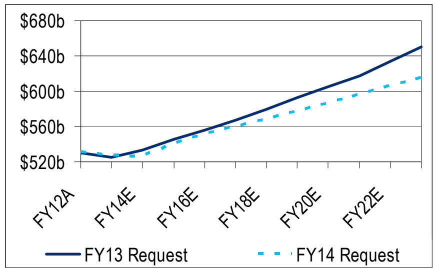
In both periods, we see an increasing mix toward tooth vs. tail with the investment accounts set to outgrow the non-weapons accounts, even as the DoD removes funds from the long-term budget plan. We note that the reductions fall more heavily on investment in the near-term whereas the burden shifts to operations over the long-term as planned reforms take hold. We note that these reforms are particularly politically tough sells, so there's always a risk that over the long-term the investment accounts are crowded out by operations cost the DoD can not control due to an intransigent Congress.

Figure 6. Slowing Growth from FY14-18

Base	**(14 bps)**
Procurement	*+79 bps*
R&D	*(20 bps)*
Investment Acct.	+41 bps
O&M	(59 bps)
Milpers & Other	(12 bps)

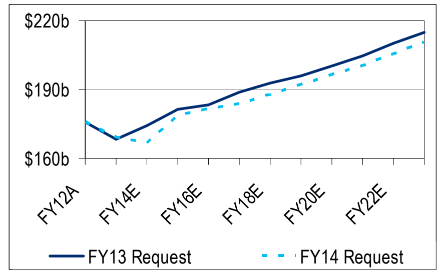
Source: Citi Research, DoD

Figure 7. Base Budget 10Y Outlook



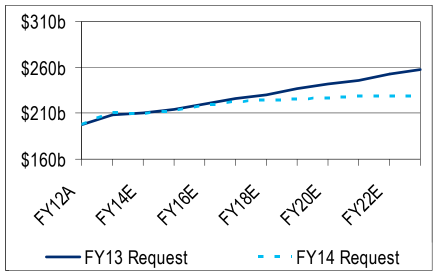
Source: Citi Research, DoD

Figure 8. Investment Account 10Y Outlook



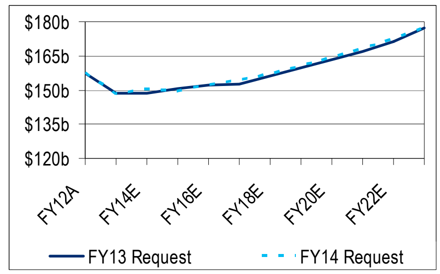
Source: Citi Research, DoD

Figure 9. O&M 10Y Outlook



Source: Citi Research, DoD

Figure 10. Milpers & Other 10Y Outlook

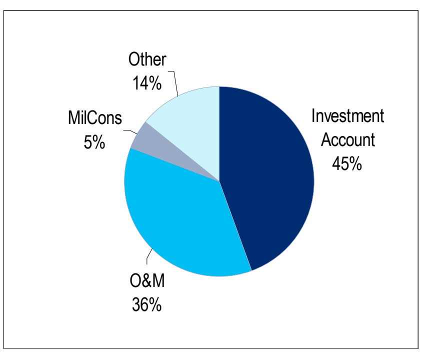


Source: Citi Research, DoD

Composition of the cuts

The investment accounts contribute more to the near-term savings than they do to the out-years. In Figure 11 we see that investment accounts make up the vast majority of the $35b of FY13-18 reductions, with R&D and Milpers/Other actually seeing a funding increase. The "other" increase is likely due to the inclusion of ~$2.4b of costs for a new base closure & realignment (BRAC) round set to take place in FY15 which is designed to generate significant savings in the out years.

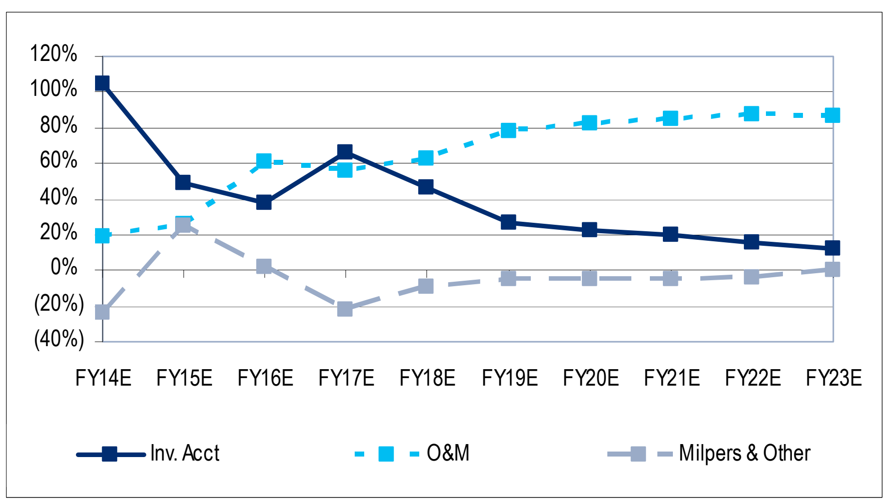
Figure 11. FYDP Savings Contribution



Source: Citi Research, DoD

We see the investment account's savings contribution rate fall precipitously from ~100% in FY14 to only 13% by the end of the 10Y period. Again, this relies on DoD's reform efforts going through since akin to the national budget, it's possible to save a lot of money over the long-term by shifting reforming cost curves today.

Figure 12. Saving Contribution rates by account (Fy14E-FY23E)



Source: Citi Research, DoD

Below, we've broken out the 10Y budget outlook by investment and compared the FY14 request to Citi's budget estimates and the FY13 estimates. We note that our own budget estimates are more punitive than that which is reflected in the FY14 request. The box highlighted in orange shows the savings contributions by year for the investment account (Procurement + R&D)

Figure 13. 10Y Outlook by Account (FY13 request vs. Citi estimate vs. FY14 request)

Base ($b)	FY12A	FY13A	FY14E	FY15E	FY16E	FY17E	FY18E	FY19E	FY20E	FY21E	FY22E	FY23E	FYDP	FY13-22
FY13 Request	**530.6**	**525.5**	**533.6**	**545.9**	**555.9**	**567.3**	**579.3**	**592.4**	**605.4**	**617.9**	**634.2**	**650.1**	**1.9%**	**2.1%**
Nominal y/y growth		(1.0%)	1.5%	2.3%	1.8%	2.1%	2.1%	2.3%	2.2%	2.1%	2.6%	2.5%		
Citi Est.	**531.0**	**527.5**	**519.6**	**519.6**	**517.6**	**514.2**	**513.7**	**512.4**	**513.4**	**516.9**	**519.5**	**524.7**	**(0.3%)**	**(0.2%)**
Nominal y/y growth		(0.7%)	(1.5%)	0.0%	(0.4%)	(0.6%)	(0.1%)	(0.3%)	0.2%	0.7%	0.5%	1.0%		
FY14 Request	**531.0**	**527.5**	**526.6**	**540.8**	**551.4**	**560.0**	**568.6**	**577.1**	**586.7**	**596.3**	**605.9**	**615.5**	**1.9%**	**1.6%**
Nominal y/y growth		(0.7%)	(0.2%)	2.7%	1.9%	1.6%	1.5%	1.5%	1.7%	1.6%	1.6%	1.6%		
Annual Savings vs. FY13 Request														
Citi Est.		2.0	(14)	(26)	(38)	(53)	(66)	(80)	(92)	(101)	(115)	(125)	(197)	(583)
FY14 Request		2.0	(7)	(5)	(5)	(7)	(11)	(15)	(19)	(22)	(28)	(35)	(35)	(117)

Procurement ($b)	FY12A	FY13A	FY14E	FY15E	FY16E	FY17E	FY18E	FY19E	FY20E	FY21E	FY22E	FY23E	FYDP	FY13-22
FY13 Request	**104.5**	**98.8**	**104.3**	**112.3**	**116.3**	**122.9**	**125.5**	**127.2**	**130.0**	**132.8**	**136.3**	**139.8**	**5.6%**	**3.6%**
Nominal y/y growth		*(5.5%)*	*5.5%*	*7.7%*	*3.6%*	*5.6%*	*2.1%*	*1.4%*	*2.2%*	*2.1%*	*2.6%*	*2.6%*		
Citi Est.	**104.5**	**99.8**	**98.7**	**101.0**	**103.9**	**106.8**	**110.7**	**115.9**	**121.7**	**129.5**	**132.1**	**133.4**	**2.9%**	**3.2%**
Nominal y/y growth		*(4.5%)*	*(1.1%)*	*2.3%*	*2.9%*	*2.8%*	*3.6%*	*4.7%*	*5.0%*	*6.4%*	*2.0%*	*1.0%*		
FY14 Request	**104.5**	**99.8**	**99.3**	**106.2**	**111.9**	**117.5**	**123.2**	**125.9**	**128.7**	**131.5**	**134.8**	**138.2**	**5.5%**	**3.4%**
Nominal y/y growth		(4.5%)	(0.5%)	6.9%	5.4%	5.0%	4.8%	2.2%	2.2%	2.1%	2.5%	2.5%		
Annual Savings vs. FY13 Request														
Citi Est.		1.0	(6)	(11)	(12)	(16)	(15)	(11)	(8)	(3)	(4)	(6)	(60)	(86)
FY14 Request		1.0	(5)	(6)	(4)	(5)	(2)	(1)	(1)	(1)	(2)	(2)	(23)	(28)
Savings as %			72%	119%	97%	73%	21%	9%	7%	6%	5%	5%	67%	24%

R&D ($b)	FY12A	FY13A	FY14E	FY15E	FY16E	FY17E	FY18E	FY19E	FY20E	FY21E	FY22E	FY23E	FYDP	FY13-22
FY13 Request	**71.4**	**69.4**	**69.8**	**69.2**	**66.8**	**65.8**	**67.3**	**68.8**	**70.3**	**71.8**	**73.7**	**75.1**	**(1.3%)**	**0.7%**
Nominal y/y growth		*(2.8%)*	*0.6%*	*(0.9%)*	*(3.4%)*	*(1.5%)*	*2.2%*	*2.3%*	*2.2%*	*2.1%*	*2.6%*	*2.0%*		
Citi Est.	**71.4**	**69.4**	**66.0**	**64.5**	**63.6**	**62.7**	**62.4**	**62.8**	**63.6**	**65.2**	**65.9**	**66.5**	**(1.4%)**	**(0.6%)**
Nominal y/y growth		*(2.8%)*	*(4.8%)*	*(2.3%)*	*(1.5%)*	*(1.4%)*	*(0.5%)*	*0.7%*	*1.2%*	*2.6%*	*1.0%*	*1.0%*		
FY14 Request	**71.4**	**69.4**	**67.5**	**72.8**	**69.5**	**66.3**	**64.6**	**66.0**	**67.5**	**68.9**	**70.6**	**72.4**	**(1.1%)**	**0.2%**
Nominal y/y growth		(2.8%)	(2.7%)	7.7%	(4.4%)	(4.6%)	(2.6%)	2.2%	2.2%	2.1%	2.5%	2.5%		
Annual Savings vs. FY13 Request														
Citi Est.		(0.0)	(4)	(5)	(3)	(3)	(5)	(6)	(7)	(7)	(8)	(9)	(20)	(47)
FY14 Request		(0.0)	(2)	4	3	0	(3)	(3)	(3)	(3)	(3)	(3)	2	(10)
Savings as %			33%	(70%)	(59%)	(7%)	25%	18%	15%	13%	11%	8%	(5%)	8%

Inv. Acct. ($b)	FY12A	FY13A	FY14E	FY15E	FY16E	FY17E	FY18E	FY19E	FY20E	FY21E	FY22E	FY23E	FYDP	FY13-22
FY13 Request	**175.9**	**168.2**	**174.0**	**181.4**	**183.2**	**188.7**	**192.7**	**196.0**	**200.3**	**204.6**	**209.9**	**215.0**	**2.9%**	**2.5%**
Nominal y/y growth		*(4.4%)*	*3.5%*	*4.3%*	*0.9%*	*3.0%*	*2.1%*	*1.7%*	*2.2%*	*2.1%*	*2.6%*	*2.4%*		
Citi Est.	**175.9**	**169.2**	**164.8**	**165.5**	**167.5**	**169.5**	**173.0**	**178.7**	**185.3**	**194.7**	**197.9**	**199.9**	**1.2%**	**1.8%**
Nominal y/y growth		*(3.8%)*	*(2.6%)*	*0.4%*	*1.2%*	*1.2%*	*2.1%*	*3.3%*	*3.7%*	*5.1%*	*1.7%*	*1.0%*		
FY14 Request	**175.9**	**169.2**	**166.8**	**179.0**	**181.5**	**183.8**	**187.7**	**191.9**	**196.2**	**200.4**	**205.4**	**210.6**	**3.0%**	**2.2%**
Nominal y/y growth		(3.8%)	(1.4%)	7.3%	1.4%	1.3%	2.1%	2.2%	2.2%	2.1%	2.5%	2.5%		
Annual Savings vs. FY13 Request														
Citi Est.		1.0	(9)	(16)	(16)	(19)	(20)	(17)	(15)	(10)	(12)	(15)	(80)	(133)
FY14 Request		1.0	(7)	(2)	(2)	(5)	(5)	(4)	(4)	(4)	(5)	(4)	(21)	(37)
Savings as % of total base budget savings														
Citi Est.			66%	61%	41%	36%	30%	22%	16%	10%	10%	12%	40%	23%
FY14 Request			104%	49%	38%	66%	47%	27%	22%	20%	16%	13%	62%	32%

O&M ($b)	FY12A	FY13A	FY14E	FY15E	FY16E	FY17E	FY18E	FY19E	FY20E	FY21E	FY22E	FY23E	FYDP	FY13-22
FY13 Request	**197.2**	**208.8**	**210.8**	**213.9**	**220.6**	**226.0**	**230.5**	**236.6**	**241.7**	**246.3**	**252.9**	**257.9**	**2.0%**	**2.2%**
Nominal y/y growth		*5.9%*	*0.9%*	*1.5%*	*3.1%*	*2.5%*	*2.0%*	*2.7%*	*2.1%*	*1.9%*	*2.7%*	*2.0%*		
FY14 Request	**197.2**	**210.1**	**209.4**	**212.6**	**217.9**	**221.9**	**223.8**	**224.7**	**226.3**	**227.9**	**228.0**	**227.8**	**1.7%**	**0.9%**
Nominal y/y growth		6.5%	(0.3%)	1.5%	2.5%	1.9%	0.8%	0.4%	0.7%	0.7%	0.0%	(0.1%)		
Annual Savings vs. FY13 Request														
FY14 Request		1.3	(1)	(1)	(3)	(4)	(7)	(12)	(15)	(18)	(25)	(30)	(16)	(86)
Savings as % of total base budget savings														
FY14 Request			19%	26%	61%	56%	62%	78%	82%	85%	88%	87%	47%	73%

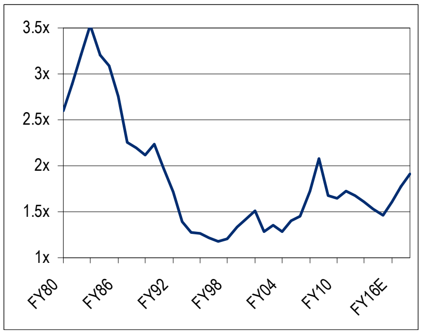
Source: Citi Research, DoD

Positive modernization mix-shift continues

Within the base investment account, DoD continues to emphasize procurement over R&D, a positive mix-shift for defense industry margins since profitability in procurement is often tied to execution (~15% margins), whereas R&D margins are often capped as part of cost-plus contracts (~10% margins). We view this shift as positive for companies with proven abilities to execute.

The base FY14 procurement to R&D ratio (P:RD) is up to 1.47x, but the rate is expected to get to 1.91x by the end of the FYDP which would be in line with the FY80-10 average of 1.9x (Figure 15).

Figure 14. P:R&D (FY81-FY17E)



Source: DoD, Citi Research

Figure 15. Procurement to R&D ratio continues to rise through the FYDP period

FY14 Request	FY11	FY12A	FY13A	FY14E	FY15E	FY16E	FY17E	FY18E
Procurement	103	105	100	99	106	112	117	123
R&D	75	71	69	68	73	70	66	65
Investment Acct.	**$178**	**$176**	**$169**	**$167**	**$179**	**$181**	**$184**	**$188**
Total Base Budget	**$529**	**$531**	**$528**	**$527**	**$541**	**$551**	**$560**	**$569**
Base P:R&D	**1.38x**	**1.46x**	**1.44x**	**1.47x**	**1.46x**	**1.61x**	**1.77x**	**1.91x**
Base Inv Acct. Share	34%	33%	32%	32%	33%	33%	33%	33%

Source: Citi Research, DoD

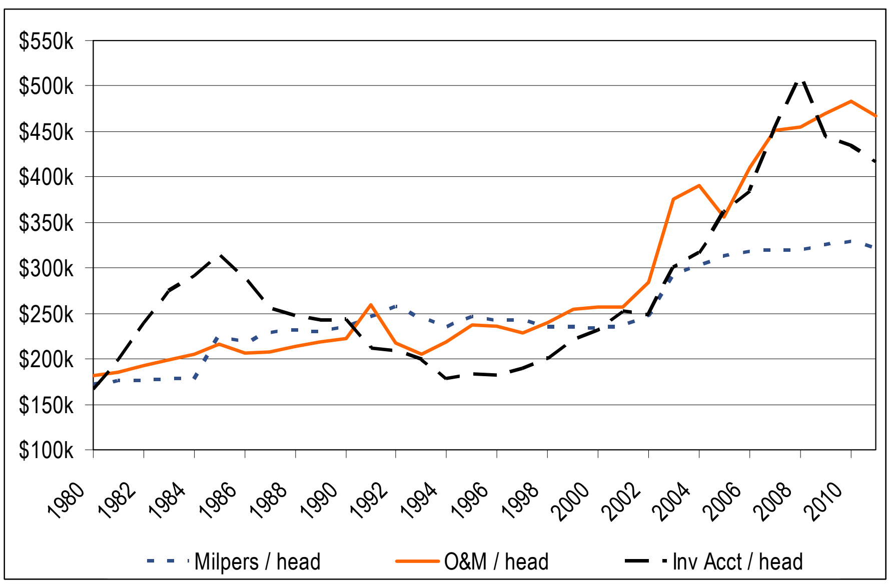
Personnel & operations costs

Per head costs have soared over the last decade. The FY14 picks up where FY13 left off: attacking cost growth by reducing end-strength and (trying to) reduce personnel costs.

DoD is proposing several reforms to control O&M and Personnel costs over the long-run. These include a round of BRAC in FY15, limiting health care costs in line with national trends, reducing civilian payroll, and limiting pay raise to 1%. Together, these comprise ~35% of the FYDP's ~$35b in savings. We expect DoD to continue to pursue reforms such as these in order to get a better control over what are considered out of control accounts.

Both O&M and Investment Accounts have soared on a per head basis over the last decade. We expect per head modernization spending to remain relatively resilient due to the need to field an increasingly modern military with a reduced end-strength.

Figure 16. Per Head Budget by Title (constant $000)



Source: DoD

Where's the debate?

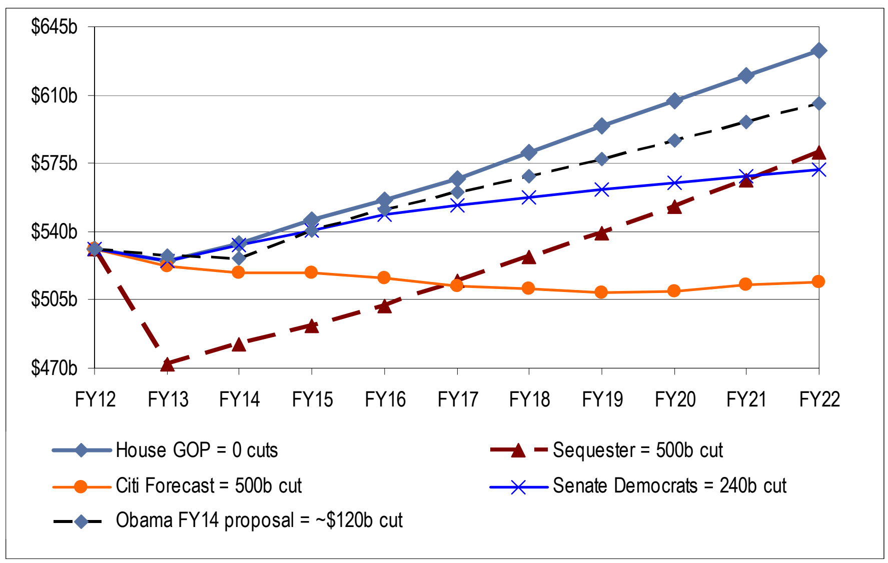
The negotiation now moves to Congress as each Party tries to figure out how to neutralize sequester by finding long-term deficit reduction solutions.

President Obama's budget is the final piece of the puzzle needed for a serious budget negotiation between the House, the Senate, and the White House. Of importance is that this is the first time in several years that the Senate is contributing a specific budget resolution to the debate.

DoD highlights how the President's budget is essentially in between the House Republican and Senate Democrat proposals. Whereas the FY14 plan cuts ~$120b from the 10Y outlook (FY13-22), the Senate cuts $240b and the House cuts zero. We note that each of these plans back-loads the cuts, unlike sequester which has $500b of front-loaded cuts. The three proposals are also kinder to the defense budget than our base case scenario which envisions the same amount of cuts as sequester for FY13-21, but back-loaded. We still believe that this flat-lining is the most politically feasible outcome, although each party will look for a better outcome over the coming months.

The three proposals are now on the table. The President's FY14 plan splits the middle between the House & Senate, while neutralizing sequester.

Figure 17. Dueling Budget Visions



Source: Citi Research

Program Commentary

Figure 18. Program Performance

	Y/Y Change	vs. Estimate
Crawl	(23%)	(25%)
Float	15%	28%
Fly	(2%)	3%
Missile	3%	5%

Source: Citi Research, DoD

The FY14 budget was relatively unspectacular from a program perspective. By our math, the programs that crawl underperformed those that fly and float. Of the major ground-based programs, the aggregate funding request was down 23% y/y vs. floating programs which were up 15%. Crawling programs also underperformed last year's projection as DoD cut more deeply into its ground-based portfolio. These programs missed FY14 expectations by 25% while floating beat last year's projections thank in large part to an additional $2.4b for another VA-class submarine. See Figure 18 for the breakdown.

Major Programs

The below chart shows how some of the largest major acquisition programs vary with their FY13 request from a y/y perspective as well as how their FY14 request compares to what was projected a year ago. We note that some of the larger plus ups come with an extra VA-class sub being added to the budget (helps GD ad HII) and the addition of 21 Growler aircraft (good for Boeing).

Figure 19. Select major acquisition programs and how they compare y/y and to their FY14 projections

Program	FY12	FY13 Request	FY14 Projection	FY14 Request	FY13-14	FY14 vs. Est.	FY14 delta vs. Est.	Ticker(s)	Comment
F-35	9,162	9,171	8,900	8,445	(8%)	(5%)	(455)	LMT, NOC	Cost adjustments
VA-Class Sub	4,794	4,258	3,000	5,418	27%	81%	2,418	HII, GD	Added one to funding plan
P-8A	2,935	3,258	4,000	3,764	16%	(6%)	(236)	BA	In line
LCS	2,118	2,337	2,400	2,390	2%	(0%)	(11)	LMT, Austal	In line
EA-18G	1,040	1,075	40	2,013	87%	4,932%	1,973	BA, NOC	Added aircraft to previous curtailment plans
DDG-51	2,081	3,515	2,100	2,004	(43%)	(5%)	(96)	GD, HII	In line as quantity procured falls from 2 to 1...but could pick back up
Carrier Refuel	694	1,613	1,700	1,951	21%	15%	251	HII	Long-lead for Washington & completion for Lincoln
EELV	1,696	1,688	2,000	1,881	11%	(6%)	(119)	BA/LMT	Cost savings w/ new entrants
V-22	2,777	1,955	1,900	1,867	(5%)	(2%)	(33)	BA, TXT	In line
Carrier	692	782	1,400	1,680	115%	20%	280	HII	Funds 2nd year of Kennedy construction, Ford costs & some cost overrun
KC-46A	819	1,816	1,600	1,559	(14%)	(3%)	(41)	BA	R&D continuing
Aegis	1,517	1,382	1,500	1,518	10%	1%	18	LMT, RTN	In line
Trident II	1,563	1,512	1,221	1,463	(3%)	20%	243	LMT	Funds advanced component development
E-2D	1,206	1,159	1,300	1,416	22%	9%	116	NOC	Entering into FRP
WIN-T	1,016	1,225	1,260	1,278	4%	1%	18	GD	In line
GPS	1,525	1,368	1,275	1,276	(7%)	0%	1	LMT, RTN, LLL, COL	In line
C-5	1,164	1,280	1,250	1,218	(5%)	(3%)	(32)	LMT	In line
SSBN(X)	1,047	565	860	1,084	92%	26%	224	GD, HII	Funds continued R&D
GMD	1,143	903	900	1,034	14%	15%	134	BA	More emphasis on GMD in the US in light of NK threat
CH-47	1,551	1,430	1,088	1,009	(29%)	(7%)	(79)	BA	MYP saves money
SBIRS	947	903	925	936	4%	1%	11	LMT	In line
Global Hawk	1,457	1,251	520	894	(29%)	72%	374	NOC	Ending Block 40 procurement but funding other programs
Apache	767	1,180	1,100	884	(25%)	(20%)	(216)	BA	Delayed 41 new builds beyond FY18
H-1	806	852	900	868	2%	(4%)	(32)	TXT	In line
THAAD	986	778	879	850	9%	(3%)	(29)	LMT, RTN	In line
F-22	860	808	800	746	(8%)	(7%)	(55)	LMT	In line
JTRS	1,140	1,625	950	718	(56%)	(24%)	(232)	GD, COL, BAE, XLS, LMT, VSAT	Reduced MNVR scope
AEHF	937	786	740	653	(17%)	(12%)	(88)	LMT	Cost savings
F-15	448	364	800	622	71%	(22%)	(178)	BA	Cost savings on upgrades
PAC-3 MSE	161	82	610	609	644%	(0%)	(1)	RTN	In line
GCV	435	640	1,417	592	(7%)	(58%)	(825)	BAE or GD	Reduced TD participants to 1 from 2
AMRAAM	389	423	600	524	24%	(13%)	(76)	RTN	Minor reduction
Afloat FSB	0	0	0	524	NA	NA	524	TBD (GD, HII)	Developing new capability using an MLP platform
Standard Family	419	463	500	444	(4%)	(11%)	(56)	RTN	Minor reduction
PAC-3	736	963	319	337	(65%)	6%	18	RTN	In line
M-1	584	301	250	279	(7%)	12%	29	GD	In line; funds for fielding not new procurement
JLTV	45	117	125	135	15%	8%	10	TBD (BAE, LMT, OSK)	In line
UH-72	250	272	260	96	(65%)	(63%)	(163)	EADS	Reduced quantities

Source: Citi Research, DoD

Other program winners & losers

Although the cuts were small and most reported in the media over the weeks leading up the budget, there were some notable moves for airborne assets.

As far as we could tell, the biggest losers were Boeing's Apache (~40 new builds delayed), Northrop Grumman's Global Hawk (Air Force looking to end Block 40 procurement), and the GD/BAE Ground Combat Vehicle which is being teased out and reduced to one competitor sooner than expected. There might also be some budgetary softness for NOC's unmanned vertical lift platform, the Fire Scout, as the Navy considers how best to deliver the technology to the fleet (although we still consider it an attractive capability).

LMT's F-35 notably escaped this budget unscathed…for the first time in several years.

In our view, the biggest winners were Lockheed's F-35 to the extent that for the first time in a few years it made it through a budget request without being cut; Boeing's tanker which continues to be on schedule; Boeing's E/A-18G which saw a $2b plus-up; shipbuilding (GD/HII) in general which saw all of its large programs well-supported; and Lockheed's C-130 which is set to enter into a new MYP which saves the government money while providing some certainty to LMT (in addition to margin opportunity later in the program). The other "headline" cancellation was the PTSS (Precision Tracking Space System), a space-based radar designed to monitor missile launches which got behind schedule and over-budget (we note that every prime appeared to be at least partially involved in this developmental program).

In addition to our take on the budget request, DoD highlighted the below specific programs generating savings over the FYDP:

The F-18 reduction is offset by the additional Growlers.

The JSF reduction is driven by eliminating cost growth.

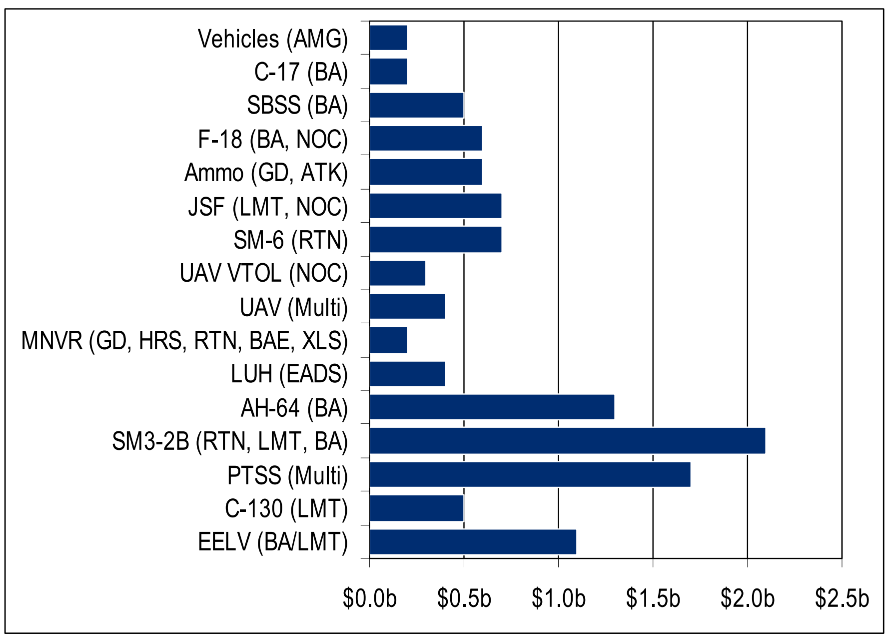
EADS' LUH is being curtailed at the final 10 units, while Boeing's news Apaches are being delayed (although they're offset by a plus up in remanufactured Apache).

The SM3-2B restructure pays for more ground-based missile defense (BA) and RTN radars.

C-130 savings are related to those generated by the MYP.

The EELV savings are driven by the expectation that new competitors will drive down price.

Figure 20. DoD-Identified FYDP Savings Contributors (relevant ticker in parentheses)



Source: Citi Research, DoD

What's Priced In?

Defense stocks seem to be 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 various ways that DoD can roll out the cuts. 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 seems too negative on defense, pricing in a perpetual reduction in free cash flow anywhere from 1-6% (see Figure 21).

Even if we adjust for the potential impact of sequester, we still consider the market to be overly negative. For instance, even when haircutting the starting point (2013E UFCF) in our zero-growth model by 20% to account for budget reductions, the market still prices in perpetual reductions for the defense primes except for LMT which has more attractive cash pension returns on the horizon vs. the other companies (Figure 22). 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 21. 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	$23,978	132.2%	(2.9%)
LMT	$33,705	$30,920	109.0%	(0.6%)
NOC	$23,128	$16,576	139.5%	(3.3%)
RTN	$34,555	$19,111	180.8%	(5.9%)

Source: Citi Research, Bloomberg

Figure 22. FCF reduction implied w/ "sequester-adjusted" 2013E UFCF

	5% haircut	10% haircut	15% haircut	20% haircut	25% haircut	30% haircut
GD	(2.3%)	(1.7%)	(1.1%)	(0.5%)	0.1%	0.6%
LMT	(0.2%)	0.2%	0.6%	1.0%	1.3%	1.7%
NOC	(2.7%)	(2.1%)	(1.5%)	(0.9%)	(0.3%)	0.3%
RTN	(5.2%)	(4.5%)	(3.9%)	(3.2%)	(2.5%)	(1.8%)

Source: Citi Research, Bloomberg

Stock Performance

On average, defense stocks have posted gains of 250bps in the 30 days after budget release, representing 150bps of market outperformance. We call this the "better than feared" trade.

This year is setting up similar to those previous with defense stocks outperforming heading into the budget submission as the market realizes that the government will still ask for hundreds of billions dollars for defense budgets…that things won't be "that bad." Of course, the main difference this year is that sequester looms overhead. The 1-2 month setup is similar to previous years', but the 3-month setup is markedly different with defense significantly underperforming due in part to the broader market rally which put defensive stocks out of favor in February.

- **1-2 month setup:** Over the past 30 and 60 days, defense stocks have outperformed the market by 380 and 500 bps, respectively, based in part on a tough February which set stocks up for a relief rally in March. This 1-2 month setup is similar to what we saw in previous years. Leading into the FY12 submission, defense stocks responded positively to Secretary Gates' budget preview on January 6, 2011. Stocks also rallied into Secretary Panetta's FY13 preview on January 26, 2012 following the announced results of the "Comprehensive Strategic Review" on January 5. We haven't had a budget preview this year, but stocks are again up in the mid-single to low-double digits heading into the budget.

- **3 month setup:** This year's 3-month setup is markedly different than the previous two years with stocks underperforming the market over the last 90 days. In our view, this is attributable to a tough February for defense following January's earnings season. In our view, 4Q earnings were strong and worthy of outperformance, but the risk-on trade coupled with sequester nervousness pushed defense names out of favor in February. For these reasons, stocks have underperformed over the last 90 days. See Figure 23.

- **Post-budget performance:** Defense stocks have generally traded well in the 30 days after a budget release – posting gains of 250bps on average across the group in absolute terms and outperforming the broader market by 150bps. See Figure 23. We expect this year's submission to mirror the past, with the “better than feared” trade setting up nicely once again.

Figure 23. Defense primes generally performed well going into & coming out of budget submissions

	FY10 Submission (5/7/09)				FY11 Submission (2/1/10)				FY12 Submission (2/14/11)				FY13 Submission (2/13/12)			
	-3M	-2M	-1M	+1M	-3M	-2M	-1M	+1M	-3M	-2M	-1M	+1M	-3M	-2M	-1M	+1M
GD	(6.2%)	47.1%	23.2%	12.7%	11.0%	4.0%	1.8%	4.9%	17.3%	9.2%	6.5%	(4.1%)	6.3%	10.8%	(0.7%)	4.2%
HII	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	15.4%	17.7%	8.8%	1.6%
LMT	0.4%	35.4%	8.0%	8.1%	7.9%	(3.3%)	(0.6%)	5.3%	17.8%	15.0%	8.6%	(3.1%)	13.3%	14.7%	8.2%	2.5%
NOC	5.8%	41.4%	6.5%	(0.9%)	15.6%	5.5%	3.7%	7.6%	11.0%	6.4%	2.2%	(5.5%)	1.4%	9.0%	2.5%	2.9%
RTN	(0.7%)	36.1%	16.1%	(2.6%)	15.8%	2.8%	2.8%	6.6%	10.8%	12.1%	1.2%	(2.1%)	10.4%	10.9%	3.4%	4.4%
Avg.	(0.2%)	40.0%	13.5%	4.3%	12.6%	2.2%	1.9%	6.1%	14.2%	10.6%	4.6%	(3.7%)	9.4%	12.6%	4.4%	3.1%
Relative	(465 bps)	721 bps	220 bps	70 bps	837 bps	319 bps	426 bps	339 bps	116 bps	345 bps	160 bps	197 bps	189 bps	142 bps	(41 bps)	(2 bps)
SP50	4.5%	32.8%	11.3%	3.6%	4.2%	(1.0%)	(2.3%)	2.7%	13.1%	7.2%	3.0%	(5.7%)	7.5%	11.2%	4.9%	3.1%

Source: Citi Research, FactSet

Figure 24. Companies mentioned

Company	RIC	Rating	Currency	Price	TP
Boeing	BA.N	1	USD	87.82	100.00
BAE Systems	BAES.L	2	GBP	3.93	3.60
Rockwell Collins	COL.N	2	USD	63.69	62.00
EADS	EAD.PA	1	EUR	38.48	48.50
General Dynamics	GD.N	1	USD	69.46	86.00
Huntington	HII.N	1	USD	51.86	58.00
Lockheed Martin	LMT.N	1	USD	95.98	110.00
Northrop Corp	NOC.N	1	USD	71.77	79.00
Raytheon	RTN.N	1	USD	58.22	69.00
Textron Inc	TXT.N	2	USD	29.14	28.00

Source: Citi Research

Appendix A-1

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