

Equities

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Huntington Ingalls Industries (HII)

Margin Story Stays on Course; Reducing PT but reiterating Buy

- Company Update
- Target Price Change
- Estimate Change

■ **Stock Call** — HII's first complete quarter as a standalone saw improving margins and a reiteration of the execution improvement story based on scheduled delivery dates. The quarter's sales miss is less of a concern to us for a name whose earnings power is driven by margins. However, we are cutting our PT to \$35 (from \$44) based on a reduced market multiple (we employ a consistent methodology of applying a 25% discount to the market). Still, we are reiterating our Buy since the story is intact.

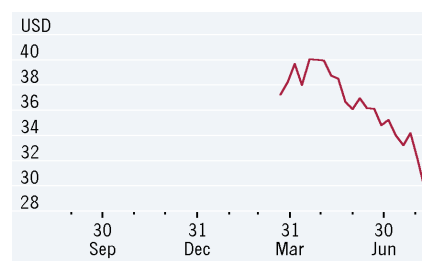
■ **Key Positives** – **1)** Strong margins at Newport (up 200 bps q/q, beat Citi est. by 20 bps) are expected to hold in, while recently reported cost overruns are built into management expectations as being a normal part of lead ship construction; **2)** Strong margins at Ingalls as restructuring story plays through (up 50 bps q/q, beat Citi est. by 60 bps), while adjusted margins were closer to 4% excluding LPD-22 adjustments, providing visibility into strength of underlying business; **3)** Generated \$186m of OCF driving cash balances to \$381m, which we expect to improve as collections pick up over the year; **4)** Reduced Avondale closure cost estimates by \$40m and reiterated confidence that all costs are recoverable; **5)** Problem ships still on track for delivery, with 3 of the 4 zero-margin ships (LPD22-24) out of the yard by the end of 2012 (these dynamics alone drive Ingalls margins by ~30bps in 2012 and then ~40bps in 2013).

■ **Key Negatives** – **1)** Missed sales estimates by ~5% and reduced outlook for 2011 by ~\$200m due to contract delays for DDG-113 and LPD-26. This likely leads to lighter sales in 2012-13, but we remind investors that HII's earnings growth comes from ships already set to deliver; **2)** Couldn't bracket potential impact of Navy plans to save money, leaving some uncertainty on the table; **3)** Pension continues to be a watch item given persistently low discount rates and weak asset performance; **4)** Possible LPD22 delivery slip into early 2012 (Navy wants more tests) could impact 4Q cash collection.

■ **Reducing PT** — Shares now trade at ~7x FTM EPS. We believe HII should trade at a 25% discount to the market multiple of 11.5x in line with where the defense industry has historically traded. This yields a PT of \$35 applied to our FTM EPS est. of \$4.04.

Buy/Medium Risk	1M
Price (11 Aug 11)	US\$27.83
Target price	US\$35.00
	from US\$44.00
Expected share price return	25.8%
Expected dividend yield	0.0%
Expected total return	25.8%
Market Cap	US\$1,357M

Price Performance (RIC: HII.N, BB: HII US)



EPS	Q1	Q2	Q3	Q4	FY	FC Cons
2010A	0.85A	-0.22A	0.85A	1.27A	2.73A	na
2011E	0.92A	0.80A	0.82E	0.97E	3.51E	3.59E
Previous	0.92A	0.87E	0.90E	1.02E	3.71E	na
2012E	0.84E	0.93E	0.93E	1.08E	3.78E	3.94E
Previous	0.86E	0.99E	1.05E	1.12E	4.04E	na
2013E	0.99E	1.04E	1.07E	1.24E	4.35E	4.79E
Previous	1.05E	1.14E	1.21E	1.29E	4.69E	na

Source: Company Reports and dataCentral, CIR. FC Cons: First Call Consensus.

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

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Fiscal year end 31-Dec	2009	2010	2011E	2012E	2013E
Valuation Ratios					
P/E adjusted (x)	12.1	10.2	7.9	7.4	6.4
EV/EBITDA adjusted (x)	4.0	3.6	3.9	3.8	3.2
P/BV (x)	1.0	1.0	0.9	0.8	0.7
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0
Per Share Data (US\$)					
EPS adjusted	2.30	2.73	3.51	3.78	4.35
EPS reported	2.30	2.73	3.51	3.78	4.35
BVPS	26.67	28.65	30.32	33.74	37.82
DPS	0.00	0.00	0.00	0.00	0.00
Profit & Loss (US\$M)					
Net sales	6,292	6,723	6,498	6,576	6,608
Operating expenses	-6,081	-6,475	-6,127	-6,165	-6,151
EBIT	211	248	371	411	457
Net interest expense	-36	-40	-104	-118	-117
Non-operating/exceptionals	1	-2	0	0	0
Pre-tax profit	176	206	267	293	340
Tax	-52	-71	-93	-104	-121
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	124	135	174	189	219
Adjusted earnings	124	135	174	189	219
Adjusted EBITDA	514	577	565	591	637
Growth Rates (%)					
Sales	1.7	6.8	-3.3	1.2	0.5
EBIT adjusted	109.0	17.5	49.5	10.8	11.3
EBITDA adjusted	56.2	12.3	-2.1	4.6	7.9
EPS adjusted	105.4	18.5	28.8	7.5	15.1
Cash Flow (US\$M)					
Operating cash flow	-88	359	353	350	426
Depreciation/amortization	186	183	181	180	180
Net working capital	-269	22	-55	-23	24
Investing cash flow	-178	-189	-221	-177	-169
Capital expenditure	-181	-191	-221	-177	-169
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	266	-170	642	0	0
Borrowings	266	-170	642	0	0
Dividends paid	0	0	0	0	0
Change in cash	0	0	773	173	256
Balance Sheet (US\$M)					
Total assets	5,001	5,203	6,072	6,290	6,510
Cash & cash equivalent	0	0	774	947	1,203
Accounts receivable	537	728	675	657	657
Net fixed assets	1,977	1,997	2,043	1,996	1,941
Total liabilities	3,564	3,785	4,572	4,601	4,602
Accounts payable	314	274	290	312	311
Total Debt	820	820	1,873	1,873	1,873
Shareholders' funds	1,437	1,418	1,500	1,689	1,908
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	8.2	8.6	8.7	9.0	9.6
ROE adjusted	10.3	9.5	11.9	11.9	12.2
ROIC adjusted	4.8	5.0	7.4	7.7	8.5
Net debt to equity	57.1	57.8	73.3	54.8	35.1
Total debt to capital	36.3	36.6	55.5	52.6	49.5

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Reviewing Our Long Thesis

In our view, the company is likely to generate 17% annual earnings growth through 2013E driven mainly by segment margin expansion (~270 bps through 2013E). In a nutshell, HII is the only real turnaround story in our defense coverage universe.

We expect FCF generation to pick up in 2012E and 2013E based on restructuring costs abating and net income improving, and be applied toward debt retirement and dividends.

We expect sales to fall in 2011 on slowed Navy acquisition to be offset by margin expansion through 2013E.

- **Very long term revenue visibility, albeit at zero growth** — The US Navy's 30 year shipbuilding plan lays out long-term goals and supports relatively steady acquisition of HII's core products over the next few decades: carriers, submarines, and amphibious ships. Of course, there could be movement in the requirements over that time period. However, ships take a long time to plan and build (i.e. 5 years for a submarine & 11 years for a carrier) and we don't expect the current backlog of \$16.8b to slip materially in the near-term. And while the backlog is only worth ~2.5 years of sales, shipbuilding contracts are notoriously lumpy.
- **Broken margins offer room for improvement** — Some poorly priced ships in backlog (LPDs 22-25 at zero margin) and Mother Nature (Hurricane Katrina) conspired to create underperforming segment margins of 4.4% in 2010 vs. GD's 10%. Loss-making Gulf Coast is to blame, as it saw negative 2% margins in 2010 vs. Newport News' 9.4%. We note that these now-zero-margin contracts were negotiated by a previous management team at Gulf Coast, which has since been replaced (as of 2008) by leaders from the Newport News operation. Delivering the low margin ships and implementing more serial production processes (vs. exquisite one-time builds) should contribute to segment margin improvement of 270 bps to ~7% in 2013E. By 2016, we believe HII can achieve total operating margins of 9% (vs. 3.7% in 2010E).
- **Cash generation likely allows for improved net debt position** — We expect the company to generate FCF of \$130m in 2011E, growing to \$170m in 2012E, and to \$250m in 2013E as near term cash headwinds from restructuring costs abate (we are now modeling for ~\$140m in cash costs for the Avondale closure through 2013E as HII reduced its estimates by ~\$40m in 2Q). Over the long-run, we expect operating improvements to drive leverage ratios lower (2.7x Net Debt/adj. EBITDA today down to 1.1x in 2013E) and for the company to use excess cash to pay down debt and institute a dividend. In our view, both share buybacks and acquisitions are unlikely in the near-term.

Figure 1. Earnings Snapshot

\$ in Millions except EPS	2010	1Q11	2Q11	3Q11E	4Q11E	2011E	2012E	2013E
Revenue	\$6,723	\$1,684	\$1,563	\$1,586	\$1,665	\$6,498	\$6,576	\$6,608
Y/Y Revenue Growth	7%	-2%	-3%	-5%	-4%	-3%	1%	0%
Operating Profit	\$248	\$85	\$91	\$92	\$103	\$371	\$411	\$458
Total Operating Margin	3.7%	5.0%	5.8%	5.8%	6.2%	5.7%	6.3%	6.9%
Pre-Tax Income	\$206	\$70	\$61	\$62	\$74	\$267	\$293	\$340
Income Taxes	(71)	(25)	(21)	(22)	(26)	(94)	(104)	(121)
Effective Tax Rate	34.5%	35.7%	35.1%	35.1%	35.1%	35.2%	35.5%	35.5%
Net Income	\$135	\$45	\$40	\$40	\$48	\$173	\$189	\$220
Diluted EPS	\$2.73	\$0.92	\$0.80	\$0.81	\$0.96	\$3.49	\$3.78	\$4.35
Avg. Diluted Shares	49.5	48.8	49.6	49.7	49.8	49.5	50.1	50.5

Source: Citi Investment Research and Analysis, Company Reports

Model & Price Target Changes

We decrease our estimates in 2011E-13E driven by a number of factors:

- Lighter volumes at Newport and Ingalls due to 2Q's 7% miss vs. our estimates. While the company expects to make up for the ~\$200m delayed from 2011 to 2012, we are taking a more conservative approach assuming the Navy slows its spending. However, we still envision VA-class sub ramps and already contracted surface combatant work to drive some growth in 2012, followed by flattening in 2013.
- Higher net interest expense outlook due to 2Q11 exceeding our expectations by 2% (\$30m expense vs. \$29m expense estimate)
- Higher share count due to greater than expected option dilution in 2Q

Offset by:

- Improved Ingalls margin expectations due to 2Q11's outperformance (2.7% vs. our estimate of 2.1%)

Our price target falls to \$35 from \$44 primarily due to our reduced target multiple:

- Lower market multiple (now 11.5x FTM EPS vs. previous 14x) yields lower target multiple (25% discount in line with where defense companies historically trade in relation to the market).
- Lower out-year estimates due to lighter sales expectations contributed ~\$2 of our PT reduction.

Figure 2. Model Changes

	3Q11E		FY11E		FY12E		FY13E		Comments
	Old	New	Old	New	Old	New	Old	New	
<i>\$ millions except EPS</i>									
Net Sales	\$1,646	\$1,586	\$6,719	\$6,498	\$6,708	\$6,576	\$6,668	\$6,608	~\$200m sales slipping across the out-years on slower acquisition
Ingalls	\$741	\$712	\$3,000	\$2,892	\$2,928	\$2,875	\$2,819	\$2,801	
Newport News	\$921	\$892	\$3,787	\$3,675	\$3,848	\$3,773	\$3,917	\$3,879	
Q/Q Change	(2.0%)	1.5%	-	-	-	-	-	-	
Y/Y Change	(1.1%)	(4.8%)	(0.1%)	(3.3%)	(0.2%)	1.2%	(0.6%)	0.5%	FY12 and FY13 make up slightly for slips out of FY11
Segment Op. Margin	6.2%	6.2%	5.9%	6.0%	6.5%	6.7%	7.0%	7.1%	Better performance at Ingalls
Ingalls	2.1%	2.5%	2.2%	2.5%	2.8%	3.1%	3.7%	3.9%	Outperformance in 2Q drives better outlook
Newport News	9.3%	9.1%	8.7%	8.7%	9.3%	9.3%	9.3%	9.3%	Strong performance in 2Q confirms outlook
Pension Expense	(4)	(4)	(16)	(16)	(16)	(16)	0	0	No change this quarter but a watch-item going forward
Total Op. Margin	5.9%	5.8%	5.7%	5.7%	6.3%	6.3%	7.0%	6.9%	
Net Interest Exp.	(29)	(30)	(103)	(104)	(116)	(118)	(115)	(117)	Higher than expected 2Q feeds through to rest of years
Tax Rate	35.4%	35.1%	35.5%	35.2%	35.5%	35.5%	35.5%	35.5%	No material change
EPS	\$0.90	\$0.81	\$3.71	\$3.49	\$4.04	\$3.78	\$4.69	\$4.35	Reduced sales, higher shares & interest vs. stronger margins
Diluted Shares O/S	48.8	49.7	48.8	49.5	48.8	50.1	48.8	50.5	Expecting option dilution going forward
	Y/Y%		FY11E		FY12E		FY13E		
Net Sales			(0.1%)	(3.3%)	(0.2%)	1.2%	(0.6%)	0.5%	
Ingalls			(0.9%)	(4.5%)	(2.4%)	(0.6%)	(3.7%)	(2.6%)	
Newport News			0.3%	(2.6%)	1.6%	2.6%	1.8%	2.8%	

Source: Citi Investment Research and Analysis, Company Reports

Reviewing 2Q11

EPS of \$0.80 missed the Street by 2c on sales. Sales of \$1.56b missed Citi (\$1.68b) and Street (\$1.65b), representing a \$0.09 EPS headwind vs. Citi's \$0.87. This was largely offset by better margins (\$0.08 vs. Citi), with a variety of non-operating items (deferred state tax, interest, and higher share count) contributing the rest of the difference (\$0.06).

Given the lumpy nature of shipbuilding revenue we were generally not too concerned by a sales miss, and we find more confidence in the better operating results. Ingalls posted 2.7% margins (up 40bps y/y on an adjusted basis), besting our estimates by 60bps driven by improved performance, and Newport News margins were 9.1% (up 200 bps q/q, down 10bps y/y). Cash balances were strong and in line with guidance at \$381m after a lighter than expected 1st quarter. Backlog is down ~\$500m q/q but shipbuilding backlog is notoriously lumpy, and it still represents ~2.5 years of sales.

Figure 3. Estimate v. Actual

\$ in Millions except EPS	2Q11			Comments on the Quarter	2Q10	
	Reported	Estimate	Var.		Actual	Y/Y
Segment Sales						
Ingalls	708	\$756	-6.4%	DDG restart not hitting yet; 1st contract awarded in 2Q	714	(0.8%)
Newport News	872	940	-7.2%	Lower RCOH and construction offset by Lincoln RCOH planning	913	(4.5%)
Intersegment eliminations	(17)	(17)	0%		(17)	
Net sales	\$1,563	\$1,679	-7%	9c headwind	\$1,610	(3%)
Operating Margin						
Ingalls	2.7%	2.1%	58 bps	Stronger execution (2Q10 included 113m charge on Avondale closure)	-13.2%	1,585 bps
Newport News	9.1%	8.9%	21 bps	Stronger execution, but down y/y on lower volume & mix shift	9.2%	(14 bps)
Segment Op. Margin	6.3%	5.9%	37 bps	8c tailwind	-0.6%	689 bps
Unallocated expenses	-0.3%	-0.2%	(2 bps)		-0.9%	61 bps
Pension income (expense)	-0.2%	0.0%	(19 bps)		0.2%	(44 bps)
Total Op. Margin	5.8%	5.7%	16 bps		-1.2%	706 bps
Operating Income						
Ingalls	19	16	20%		(94)	(120%)
Newport News	79	83	-5%		84	(6%)
Segment Operating Income	98	99	-1%		(10)	(1080%)
Post-retirement benefits	(4)	(4)	0%		(14)	(71%)
Other	(3)	0	NA	4c headwind on deferred state tax	4	-175%
Other Income	(7)	(4)	75%		(10)	-30%
Total operating income	\$91	\$95	-4%		(\$20)	-555%
Interest Expense	(30)	(29)	2%	1c headwind	(10)	200%
Other	0	0	NA		0	-
Earnings before taxes	61	66	-7%		(30)	(303%)
Taxes	(21)	(23)	-8%		19	(213%)
Effective tax rate	35.1%	35.4%	(32 bps)		63.3%	n/a
Net earnings	\$40	\$42	(7%)		(\$11)	nm
Reported net income	47	42	10%		2	2230%
Diluted EPS (cont ops)	\$0.80	\$0.87	(8%)	Missed on below-line items (margins offset weak sales in our model)	(\$0.22)	nm
Diluted shares o/s	49.6	48.8	2%	1c headwind on accelerated option dilution from spin	50.6	-2%

Source: Citi Investment Research and Analysis

Summary Models

Figure 4. Income Statement

	2008	2009	2010	1Q11	2Q11	3Q11E	4Q11E	2011E	2012E	2013E
Sales										
Ingalls	2,848	2,865	3,027	761	708	712	712	2,892	2,875	2,801
Newport News	3,427	3,534	3,775	940	872	892	972	3,675	3,773	3,879
Intersegment eliminations	(86)	(107)	(79)	(17)	(17)	(17)	(18)	(69)	(72)	(72)
Total Sales	\$6,189	\$6,292	\$6,723	\$1,684	\$1,563	\$1,586	\$1,665	\$6,498	\$6,576	\$6,608
Operating Income										
Ingalls	(1,433)	(29)	(61)	17	19	18	18	72	89	110
Newport News	(895)	313	355	67	79	81	92	319	350	360
Segment Operating Income	(2,328)	284	294	84	98	99	110	391	439	470
Operating Margin										
Ingalls	(50.3%)	(1.0%)	(2.0%)	2.2%	2.7%	2.5%	2.5%	2.5%	3.1%	3.9%
Newport News	(26.1%)	8.9%	9.4%	7.1%	9.1%	9.1%	9.5%	8.7%	9.3%	9.3%
Segment Operating Margin	(37.6%)	4.5%	4.4%	5.0%	6.3%	6.2%	6.6%	6.02%	6.68%	7.11%
Post-retirement benefits adjustment	(25)	(88)	(49)	(4)	(4)	(4)	(4)	(16)	(16)	0
Deferred state income taxes/Other Income	(1)	15	3	5	(3)	(3)	(3)	(4)	(12)	(12)
Total Operating income (loss)	(\$2,354)	\$211	\$248	\$85	\$91	\$92	\$103	\$371	\$411	\$457
Total Operating Margin	(38.0%)	3.4%	3.7%	5.0%	5.8%	5.8%	6.2%	5.7%	6.2%	6.9%
Interest expense	(40)	(36)	(40)	(15)	(30)	(30)	(30)	(104)	(118)	(117)
Other, net	0	1	(2)	0	0	0	0	0	0	0
Earnings before taxes	(\$2,394)	\$176	\$206	\$70	\$61	\$62	\$73	\$267	\$293	\$340
Income taxes	(26)	(52)	(71)	(25)	(21)	(21)	(25)	(93)	(104)	(121)
Effective tax rate	-1.1%	29.5%	34.5%	35.7%	34.5%	34.5%	34.5%	34.8%	35.5%	35.5%
Net earnings	(\$2,420)	\$124	\$135	\$45	\$40	\$41	\$48	\$174	\$189	\$219
Diluted EPS from continuing operations	-\$42.48	\$2.30	\$2.73	\$0.92	\$0.80	\$0.82	\$0.97	\$3.51	\$3.78	\$4.35
Avg. Diluted Shares	57.0	53.9	49.5	48.8	49.6	49.7	49.8	49.5	50.1	50.5

Source: Citi Investment Research and Analysis, Company Reports

Figure 5. Balance Sheet

	2008	2009	2010	1Q11	2Q11	3Q11E	4Q11E	2011E	2012E	2013E
Cash	0	0	0	225	381	575	774	774	947	1203
Accounts receivable	481	537	728	896	898	782	675	675	657	657
Inventoried costs	197	298	293	372	389	276	266	266	264	263
Deferred income taxes	208	291	284	293	286	287	292	292	295	295
Prepaid expenses & other	9	10	8	46	40	56	73	73	203	243
Total Current Assets	\$895	\$1,136	\$1,313	1,832	1,994	1,977	2,080	\$2,080	\$2,366	\$2,661
PP&E	1951	1977	1997	2006	1985	2008	2043	2043	1996	1941
Goodwill	1134	1134	1134	1134	1134	1134	1134	1134	1134	1134
Other intangibles	640	610	587	582	577	572	567	567	547	527
Pension plan asset	119	116	131	144	144	144	144	144	144	144
Misc. other assets	21	28	41	107	103	103	103	103	103	103
Total Assets	\$4,760	\$5,001	\$5,203	\$5,805	\$5,937	\$5,938	\$6,072	\$6,072	\$6,290	\$6,510
Notes payable to parent	537	537	715	0	0	0	0	0	0	0
Current Debt			0	29	29	29	29	29	29	29
Trade accounts payable	321	314	274	252	255	211	290	290	312	311
Current workers' comp	248	255	197	198	197	197	197	197	197	197
Accrued interest on notes payable to parent	185	212	239	0	0	0	0	0	0	0
Current post-retirement	176	175	146	145	145	145	145	145	145	145
Accrued employees' comp	171	173	203	166	186	186	186	186	186	186
Advance excess payments/billings	0	53	107	62	83	83	85	85	86	86
Provision for contract losses	258	81	80	61	52	52	53	53	54	54
Other current liabilities	142	132	265	211	237	238	242	242	245	245
Total Current Liabilities	\$2,038	\$1,932	\$2,226	1,124	1,184	\$1,142	1,227	\$1,227	\$1,253	\$1,252
L-T debt	\$283	283	\$105	1,851	1,844	1,844	1,844	\$1,844	\$1,844	\$1,844
Other post-retirement	484	502	567	571	573	573	573	573	573	573
Pension plan	570	379	381	393	407	407	407	407	407	407
Worker's comp	\$270	265	351	351	351	351	351	351	351	351
Deferred tax	\$81	121	99	102	113	115	115	115	117	119
Other L-T liabilities	\$73	82	56	51	54	54	55	55	56	56
Total Liabilities	\$3,799	\$3,564	\$3,785	\$4,443	\$4,526	\$4,486	\$4,572	\$4,572	\$4,601	\$4,602
Equity	\$961	\$1,437	\$1,418	\$1,362	\$1,411	\$1,452	\$1,500	\$1,500	\$1,689	\$1,908
Total liabilities & equity	\$4,760	\$5,001	\$5,203	\$5,805	\$5,937	\$5,938	\$6,072	\$6,072	\$6,290	\$6,510

Source: Citi Investment Research and Analysis, Company Reports

Figure 6. Cash Flow Statement

	2008	2009	2010	1Q11	2Q11	3Q11E	4Q11E	2011E	2012E	2013E
Net earnings (loss)	(2420)	124	135	45	40	41	48	174	189	219
Depreciation	137	156	160	40	41	40	40	161	160	160
Amortization of purchased intangibles	56	30	23	5	5	5	5	20	20	20
Goodwill impairment	2,490	-	-	-	-	-	-	-	-	-
Deferred income taxes	10	(98)	(19)	(33)	14	(1)	(5)	(25)	(3)	(0)
Gain on AMSEC reorganization	-	-	-	-	-	-	-	-	-	-
(Increase) Decrease in WC	96	(269)	22	(443)	41	170	178	(55)	(23)	24
Retiree benefits	(28)	(28)	33	31	28	-	-	59	-	-
Other non-cash transactions	(2)	(3)	5	(9)	17	4	7	19	7	2
Operating Cash Flow	\$339	(\$88)	\$359	(\$364)	\$186	\$258	\$273	\$353	\$350	\$426
Capex	(218)	(181)	(191)	(63)	(20)	(63)	(75)	(221)	(177)	(169)
Other	66	3	2	-	-	-	-	-	-	-
Investing Cash Flow	(\$152)	(\$178)	(\$189)	(\$63)	(\$20)	(\$63)	(\$75)	(\$221)	(\$177)	(\$169)
L-T Debt			(178)	1,775	(7)	-	-	1,768	-	-
Proceeds from note payable to parent			178	-	-	-	-	-	-	-
Net transfers from/(to) parent & other	(187)	266	(170)	(1,123)	(4)	-	-	(1,127)	-	-
Stock issuance/options			-	-	1	-	-	1	-	-
Share Repurchases			-	-	-	-	-	-	-	-
Dividends			-	-	-	-	-	-	-	-
Financing Cash Flow	(\$187)	\$266	(\$170)	\$652	(\$10)	\$0	\$0	\$642	\$0	\$0
Increase (decrease) in cash	-	-	-	225	156	194	198	774	173	256
Cash at beginning of period	-	-	-	-	225	381	575	-	774	947
Cash at end of period	\$0	\$0	\$0.00	\$225	\$381	\$575	\$774	\$774	\$947	\$1,203

Source: Citi Investment Research and Analysis, Company Reports

Huntington Ingalls Industries

Company description

Huntington Ingalls Industries builds aircraft carriers, submarines, surface combatants, and amphibious ships for the US Navy and Coast Guard. Employing ~38,000, HII's shipyards have been in the business for over a century. As Northrop Grumman's (NOC) shipbuilding segment since 2001, HII maintained yards in Virginia, Louisiana, and Mississippi. In July 2010, NOC announced it was exploring strategic alternatives for its shipbuilding segment, including either a spin or a sale. NOC reasoned that separating the businesses would allow each to focus on what they do best: NOC on defense electronics and aerospace engineering; HII on the capital-intensive and long-lead shipbuilding business. HII spun off from NOC and began trading as a standalone entity on March 31, 2011.

HII's three major yards are in Newport News (VA), Pascagoula (MS), and Avondale (LA). HII will close Avondale in 2013 and consolidate Gulf Coast activities into Pascagoula.

Newport News is one of only two of the nation's nuclear-capable shipyards. It's the nation's only carrier manufacturer, and one of the two submarine builders.

The Gulf Coast yards are currently located in Louisiana and Mississippi, but will be consolidated in Mississippi come 2013. The yards are marked by historic margin underperformance due to some weak bids and natural disasters. The yards produce non-nuclear powered ships that float on the water including surface combatants, amphibious warfare ships (the only builder), and support vessels.

Investment strategy

We rate the shares of Huntington Ingalls Industries (HII) Buy/Medium Risk (1M) and assign a \$35 price target using a 8.6x multiple on our FTM EPS estimate a year from now (25% discount to the market multiple of 11.5x, in line with where defense companies have historically traded on a relative basis. In our view, the company is likely to generate 17% annual earnings growth through 2013E driven primarily by segment margin expansion (~270 bps through 2013E). In a nutshell, HII represents one of the only turn-around stories in our coverage universe.

Valuation

Our target price of \$35 is derived by applying a 8.6x multiple to our FTM EPS est. 12 months from now of \$4.04. This is a ~25% discount to the market, in line with where defense-focused companies have historically traded during defense spending eras similar to this one. This equates to ~5.4x EV/EBITDA (using our LTM EBITDA estimate 12 months from now), which is also in line with typical defense industry valuation.

Risks

We rate shares of HII Medium Risk on account of three sets of puts and takes. We believe the relatively levered business is offset by positive cash flow dynamics due to improving operations and recoverable restructuring costs. Execution risk is mitigated by what we consider to be an achievable path for getting back to industry-standard margins (HII's comparable already does 9-10% margins while HII's poorly priced ships are scheduled to deliver by 2013). And in our view, heavy customer concentration (almost 100% US Navy or Coast Guard) is offset by strong revenue

visibility. However, this is reliant on a smooth wind-down at Avondale, which could incur higher than expected restructuring costs related to employee retention and work delays through 2013.

A pending False Claims Act complaint regarding misuse of Hurricane Katrina funds is another source of risk, although the company believes the claims are not likely to result in a material adverse effect. Other risks include: reduced requirements from shifts in military strategy; a competitive contracting environment; new Naval shipbuilding priorities eating into existing procurement plans (Virginia-class); and rising competition from in-sourced work at Navy shipyards as they enhance their capabilities. Broader budget pressure is also a risk given the high price tag of most Naval platforms, making them a relatively easy target for cutting. History also tells us that acts of god can negatively affect the shipbuilding business, especially in the Gulf Coast.

Appendix A-1

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IMPORTANT DISCLOSURES

Huntington Ingalls Industries (HII)

Ratings and Target Price History Fundamental Research

Analyst: Jason Gursky

Covered since March 31 2011

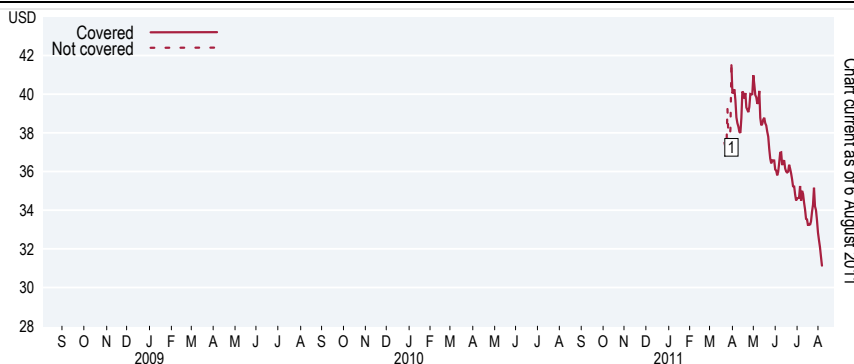


Chart current as of 6 August 2011

	Date	Rating	Target Price	Closing Price
1	31-Mar-11	*1M	*44.00	41.50

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Huntington Ingalls Industries (HII)

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

Analyst: Jason Gursky

Covered since March 31 2011

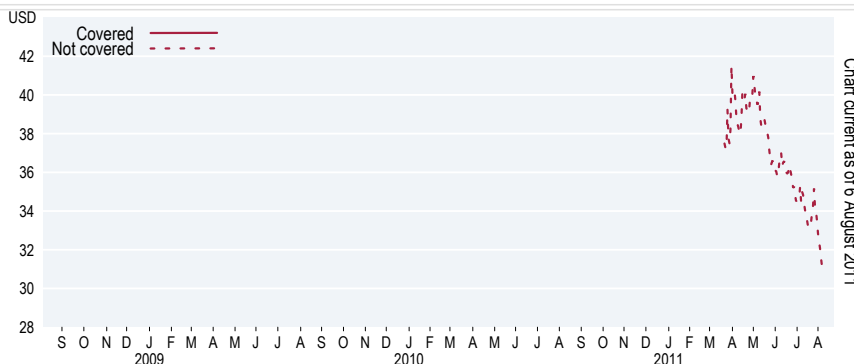


Chart current as of 6 August 2011

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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Jason Gursky; Jonathan Raviv

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