



Interview with Rick Whittington, defense industry analyst 3/6/17

Jackie: Hello, I'm Jackie Doherty with Yardeni Research. Today, I'm speaking with Rick Whittington, who has followed the defense industry on Wall Street for more than 30 years. Today, we're asking him to take a stab at predicting what defense spending will look like under the leadership of President Trump and Defense Secretary Mattis.

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Let's begin! Rick, now that things are changing dramatically in Washington, we wanted to know what you think of General Mattis, and what you think his priorities will be as the head of the Defense Department. How do you think he'll shape defense spending under President Trump?

Rick: Well, from all indications, General Mattis is a cerebral military officer who is very attuned to international and foreign relations and allied politics. He's made it clear, well before his appointment to the Defense Department under President Trump, that he would like to see the U.S. shore up allied relations, and at the same time present a more forward positioning of its forces relative to prospective adversaries. I think he means China and Russia, in particular.

He'd like to modernize the existing force, improve its technologic capability, and also moderately increase the size of the force structure.

Jackie: And so is there a specific arm or branch of the services that you think he'll be spending more on?

Rick: He has singled out the navy because of its ability to steam the oceans of the world and position itself off the coast of prospective adversaries in the Pacific Ocean. China's actions in the South China Sea over the past few years, building up its island fortifications in disputed waters come to mind. So, I would expect an emphasis, and President Trump has certainly echoed this, on a larger Navy. I also expect a forward positioning of ground forces--Army, as well as Marine forces--off the periphery of Russia in the Baltic, and possibly in southeast Asia, although thus far I haven't seen anything specific on that latter score.

Jackie: And do you think that he and Trump have similar priorities in this regard?

Rick: It sounds as if they are singing from the same sheet of music. Certainly in the campaign, and even in his first weeks in office, President Trump has rankled the feathers of--the sensibilities, perhaps is a better term-- of some key American allies.



In order to placate those concerns, he has sent General Mattis to Asia to see the leaders of South Korea, and also Japan, but also to Western Europe ... Eastern Europe to see the NATO and EU leadership. In that regard, the feedback has been positive from those foreign political figures.

Jackie: So far, President Trump has talked about increasing defense spending by about \$54 billion, do you think that that kind of large jump will get approved?

Rick: You know, I do think it's going to sail through, frankly. I believe there's a consensus in the Republican party, which controls both houses--narrowly, but nonetheless controls both houses of Congress now--to increase the funding for U.S. military forces true to the Defense Department, and also to adopt a somewhat more aggressive, I would say traditional, foreign policy posture utilizing the armed forces as part of that.

Jackie: And how do they manage to get through the budget constraints, like sequestration, that are in effect right now?

Rick: Well, sequestration is an outgrowth of a divided political landscape in Washington, where the Republicans have held both houses of Congress the last four years, and the Democrats, with President Obama, held the White House. Now we have Republicans in both the Congress and in the Executive branch, and I believe that when the fiscal 2018 Budget Act is passed this year, I would expect by the summer, that sequestration will be removed.

Jackie: Do you think they'll continue to increase the spending on defense budget going out two, three, four years?

Rick: I think the new administration intends to increase spending beyond fiscal 2018 for the Defense Department. I'm expecting mid-single-digit, maybe even high-single-digit, possibly double-digit increases again in fiscal 2019. Beyond that, in fiscal 2020 through 2022, which would be the last years of the Trump four year term, I would expect the spending growth to taper off. But, in order to get the Navy back towards the numbers, the low 300 range, even perhaps 350 combatants, surface and submarine combatants, and also to increase the fighter wings of the air force, and increase the size of the Army and the Marine corps, it's going to necessitate more than just the 10% (spending increase) that's been talked about for the current year.

Jackie: Double digits would be a major increase. Now, this certainly isn't a surprise to defense stocks. They've had a major rise since Trump was elected, even just prior to his election. So do you think they already reflect all of this good news, or is there more room for them to rally?

Rick: Certainly some of the speculation fueled by Trump's election has filtered into the stocks, but we haven't seen a budget yet. The first one will be proposed here in the weeks ahead, and I expect the budget will pass without any difficulty. The incremental funds to the contractors from the Department of Defense won't even begin to filter out for another year to a year and a half from the time that budget is



enacted, so I think in that period of time the defense stocks are going to sparkle.

Their backlogs will begin to rise, starting in the March and June quarters of 2018, and this first budget will force those backlogs higher all through calendar 2018 and into early 2019. The stocks typically perform on that basis. And don't forget that over the past eight years, the average U.S. defense contractor's revenues from the U.S. military have gone flat. The companies have succeeded in improving their earnings primarily through margin gains, which have been concerted and sizeable.

Share buybacks have played a part, but that's because the profitability of the companies has been improving. As the revenues of these companies begin to expand, later in 2018, 2019, further margin gains can be expected on the lean corporate structures that the leading defense contractors have achieved. I don't think investors are ready, yet, for the acceleration in reported earnings, which are going to flow as a consequence.

The last element to be factored in is whether the proposed tax changes of the Trump administration will be carried through. All of leading defense contractors are paying close to the statutory 35% tax rate right now. If their tax bills are due to diminish, that could further improve the earnings flow.

Jackie: Let's talk about margins for a second. You obviously think defense contractors will be able to maintain or increase their margins. Why is that, given what Trump went bargain hunting via Tweets to Boeing and Lockheed?

Rick: I think you have to realize that being a builder, the President understands, and will factor into the way he approaches the funding of the contractors, that if you can provide a company with some visibility for several years, that improves that company's wherewithal to be able to translate revenues into profitability.

I think the trade off here is he can get reduced unit cost in various items. You know, the F-35 has been visibly mentioned, but also the aircraft carriers were brought up last week when President Trump visited Huntington Ingalls' Virginia facility. If you can provide multi-year funding for big weapons platforms the unit cost can come down, but the companies can plan ahead on a more rational basis than they've been able to in many decades, and increase the profitability even on those reduced unit costs.

Don't forget, budget politics have been very topsy turvy since the end of the Vietnam War. Extending back into the 70s, we've seen a whole succession of defense budgets rise a year or two and then get cut back. We've seen big ticket, visible weapons platforms proposed, funded for a couple years, and then curtailed or scaled back, so it's really been a nightmare for the contractors for a very long time.

If they can get some visibility into what's going to be produced and in what quantity, that'll make their lives a lot easier, and I think they can improve their profitability within that context.



I think the areas that Trump's really going to go after will be shipbuilding and aircraft production. Tactical fighter aircraft production. That's where the units are most visible.

Ships are very expensive items. Aircraft carriers are now up in the 15 billion dollar range. It takes about seven years to build an aircraft carrier. If you can give a shipyard some visibility that you might pull in or accelerate the production of the carrier, or start a new one in the place of one that's perhaps a third or halfway through the production process, that allows the shipyard to operate much more efficiently.

Unit costs can come down on each carrier, but the profit margin could actually go up for the contractor, and that'd be a win win both for the country as well as private industry, and I think the same thing holds true for aircraft like the F-35, or possibly an alternative, the F-18 from Boeing, which has been bandied as a possible alternate.

Jackie: So give us a rundown. You think that revenues will increase by how much for this industry?

Rick: I think a baseline right now would be 7 to 8 percent compound annual revenue growth for the next five years, and on that, I think margins, if they expand modestly, we could be looking at mid teens--15, 16, 17 percent--earnings growth for that five year period per year.

Regardless of what Mattis and the defense people decide to purchase, there's going to be a lot of business to go around in order to rebuild fighter aircraft strength for the air force, for the Marine Corps and also ships for the Navy. We just can't overestimate how contracted the U.S. Armed Forces is today relative to 25-30 years ago, which was the era of the so-called Peace Dividend after the end of the Cold War, much less if we go back into the teeth of the Cold War back in the 1950s, early 1960s.

The U.S. military was roughly double, even triple the size that it is today, and that's in a country that had something like two-thirds fewer citizens. So, yes, the defense budget's large, it's a consequential element of the total Federal Budget, but I believe it's only 14% of total Federal spending. Back in World War II, the defense budget was basically 60% of total Federal spending. Just to try to put it into a context that you don't often see.

Now, since then, the whole landscape of national government has changed. We have programs that didn't exist back then. Everything I've seen is that the new administration's going to retain full funding for the non-discretionary areas like Social Security, Medicare, and not touch that at all. I think where the battle lines are being drawn are some of the other agencies of government, which collectively are about the same size now as the Department of Defense.

When I worked back in Washington, back in the latter part of the 1970s, defense



spending was 50% greater as the percent of the total federal budget than it is today. So there's room for the Department of Defense spending to rise here, without crippling or skewing total federal spending excessively.

Jackie: How long do you see 15 to 17 percent EPS growth?

Rick: For the next five years. The five-year budget plan that's going to be submitted will propose a number for fiscal 2018, but at the same time it will have tentative funding for 2019, 20, 21, and 22. Trump's only going to be in office for another three years and eleven months. You certainly can't count on him being re-elected in 2020, so for analytic purposes and trying to assess the prospects of defense companies, you have to look at the first budget that comes out this year and its implications for the next four years.

Even if we put in a completely new administration in 2021, they could not really affect Trump policies until 2022. So between now and the end of 2021 is the period of time in which this new budget will be in effect. I'm expecting stronger spending, increased spending each of the next four years.

Jackie: Does the 15 to 17 percent incorporate the expected reduction in corporate taxes down to, what, 15 or 20 percent?

Rick: Well, I'm assuming 18% for modeling purposes right now, which based on everything, sounds plausible. Like his defense spending plans, tax reform seems to be high on the priority list. And again, there seems to be a lot of support on Capitol Hill for it, as well. I'm expecting tax reform to go through by the middle part of the year, and I would anticipate it would be retroactive to the start of 2017.

Jackie: Do you have, let's say, three favorite names within the industry?

Rick: Sitting down and doing the calculations, not knowing exactly what the budget is at this point, the first would be Orbital Sciences, which is heavily involved in spacecraft, satellites, rocket propulsions systems, missiles, and other high-tech armaments. That'd be my number one pick.

My second would be Huntington Ingalls, the shipbuilder. That's all they do is ships for the Navy and also for the Coast Guard. They do some commercial shipping, but they also have a large repair and overhaul operation, and it sounds as if there's going to be a lot of money to get the the naval vessels that we already have out and steaming as opposed to being stuck in the port as much as they have been these last seven or eight years.

My third pick from a prospective return basis is General Dynamics, which is also involved in shipping, but they have three other major divisions, and one is land-combat equipment. Tanks, and other surface warfare vehicles, and they have a non military business which is on a roll, Gulfstream.



Those would be my three total return candidates. Based on the numbers that I'm forecasting, I could see Orbital Sciences increasing about 250% over the next four years. I could see Huntington Ingalls increasing about 170% from its current value, and General Dynamics about 140% as well. I think there's a lot of upside in these stocks.

Jackie: Are you signaling them out primarily because you expect they're going to be among the bigger beneficiaries of the spending going forward?

Rick: I do, yes. Because shipbuilding has been basically the poor stepchild of military spending for the past 30 years, the incremental benefit to the shipbuilders is the greatest. And that explains the focus on Huntington Ingalls and General Dynamics, which also makes land combat vehicles.

The last area is Orbital Sciences for munitions. High-impact, high-tech munitions, as opposed to the sort that have been utilized in these counter-insurgency wars in Afghanistan and Iraq. I think the focus of Mattis and the National Security community is turned now to China and Russia, as opposed to Iraq and Afghanistan.

Jackie: So if you had to think about what could be wrong with your bullish view of the world, what would it be?

Rick: Well, it's really hard to see, quite honestly. I think a sea change politically has taken place in Washington, for good or for bad, and they have shifted priorities. I think the defense buildup is pretty much set in stone right now. It's going to remain politically contentious because of budgetary politics and concern about how healthcare is resolved, and also how the fruits of what tax dollars are out there are distributed.

Within Republican party ranks, which is the party that does control Washington right now, I think there's a strong consensus to rebuild the armed forces, and these contractors are the distinct beneficiaries of that.

Jackie: And you think that there's a willingness to spend on defense, even if it results in increased deficits?

Rick: I think that's the way it's going to work for the next 12 months. The economy seems to be getting better. You look at the forward indicators, whether it's the ISMs or durable goods orders, economic statistics are getting better and private companies have been more upbeat about current business conditions.

As long as the economy is improving, I think there is a consensus to spend on defense. If something happens and the economy decelerates sharply and goes into the doldrums then I think thinking will change again, and there'll probably be an overhaul on these proposals that are going in right now.

Jackie: But it sounds like defense spending will occur before the spending on infrastructure



occurs.

Rick: Defense is infrastructure. Don't forget, all these companies produce the preponderance of their product and generate the vast bulk of their revenues in the United States through the employ of U.S. workers. If you start speeding up and enhancing the funding in the ship building industry and in the air craft industry, it's going to have a direct impact on wage earners, on the purchase of SUVs and pickup trucks. So, I think that there's a trickle-down effect here—which some people in the administration, Secretary Ross for example, have already highlighted—that could stimulate the economy even beyond what we've seen thus far.

Remember, the defense budget that's going to come forth here in the next several weeks that'll be tested in Congress and shifted around in the correctional committees, when it actually begins to take effect on September 1 of this year, the fiscal year 2018, those monies won't reach the U.S. economy really until early 2019. Stimulus from defense is out another year, year and a half. I think that's something that many investors might be underestimating right now.

Jackie: One thing President Trump had talked about doing in order to pay for the increase in defense spending was to decrease spending on the State Department. Do you think that those proposed cuts gets put through?

Rick: I'm guessing that that plan doesn't fly. All the words of General Mattis that I've seen tell me that he'll push back on that, and that trial balloon will puncture. I don't think State Department funding's going to be impaired, or at least nowhere near as significantly as was initially talked about.

Jackie: Rick, this has been fantastic. Thank you so much, and hopefully you'll let us call you back after the budget comes out.

Rick: Thank you, Jackie, it was my pleasure.