

# THE SCRATCH REPORT

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## The Misapprehension Towards The Earnings Of The Defense Companies

Company	Lockheed Martin Corp.
Ticker	NYSE: LMT
Price (6/26/09)	\$80.97
52 - week range	\$57.41 - \$120.30
Shares outstanding (mill.)	389
Market capitalization (mill.)	\$31,497
Dividend yield	2.8%
Price/Earnings (2009 consensus est.)	10.9x
Price/Book value	11.2x
Total debt (in millions)	\$3,805
Net Debt/capital	21.5%
Recommendation	Buy

*\*Valuations are based on an \$81.81 share price\**

### Overview

- The Lockheed Martin valuation is being held captive to the current sentiment towards U.S. defense spending, which is one of undeniably pessimistic predictions. If this pessimism is misplaced, given many decades of empirical evidence to support this presumption, the company's shares are clearly undervalued.*

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### **Investment Thesis**

Lockheed Martin is one of the few large and diversified contractors, better known as prime contractors, for the U.S. government tasked with the production of weaponry systems. Following the end of the Cold War in the early 1990s, which produced a rather dramatic shift in the nature of U.S. military defense spending, Lockheed Martin undertook several acquisitions, and ultimately constructed a franchise focused primarily on aircraft, missile, information technology, and space products.

The investor sentiment towards U.S. defense companies at the moment is overwhelmingly poor. It is widely believed that the newly appointed Obama administration will drastically reduce defense spending in favor of other programs such as healthcare, or that, at a minimum, military defense will not be a high priority for this administration. In such an environment, of course, Lockheed Martin would be selected for far fewer defense-related projects, and the company's earnings progress would certainly be suspect.

However, it is not widely understood that the current military operations in Afghanistan and Iraq are not categorized within the overall defense budget. Appropriation for these operations is known as Overseas Contingency Operations (OCO), a budget which requires approval from Congress that is entirely separate from the overall defense request. It is not clear at the moment that a reduction in spending on these operations can even be considered a reasonable short-term possibility, as conflict is still ripe in this region. It is clear, however, that a complete withdrawal from these operations is not likely, such that a sustained level of spending has to be considered a reality for the next few years.

Moreover, readers are probably not aware that the largest component of the current \$533.8 billion defense budget is not the procurement of new weaponry. Over 35% of the current budget is requested for the pay, housing, and healthcare benefits of the 2.3 million active and reserve military personnel. In addition, another 30% of the budget is dedicated to the maintenance and support of the existing fleet and military bases. As the nature of U.S. adversaries has changed since the Cold War, the current military arsenal, which has become heavily entrenched in information technology, can become quickly outdated. It is therefore unsurprising that large annual expenditures are required to merely maintain and update current systems.

Thus, only roughly 20% of annual defense spending is related to the procurement of new equipment. Historically, given the somewhat fixed nature of the defense budget, spending has been fairly consistent across several decades. In fact, since 1962, the largest year-over-year spending decline has been -9.6%, which was recorded in 1991. Volatility with respect to spending levels generally occurs during years of increases rather than during declines, which will be demonstrated later in this report. Ergo, it is not historically accurate to state that widely presumed spending reductions will actually manifest a large scale diminution to government defense spending.

It is more accurate to state that the certain programs within the defense business are subject to volatility. Depending on the location or motive of adversaries, the need for aircraft, naval vessels, or ground vehicles will change over time. Defense appropriations do not generally leave the system en masse; monies merely are subject to reallocation to various programs. Hence, diversification within each individual defense company is critical to longer term earnings clarity.

In this regard, Lockheed Martin has been selected to produce the next generation fighter jet known as the F-35. This aircraft model has been in development since 2001, and will become the cornerstone of the U.S. air arsenal. In addition, the company was successful in its bid to produce the Orion crew exploration vehicle, which will replace the current Space Shuttle program at NASA. The company is also progressing towards a next-generation Global Positioning System (GPS), which will not only have military utility, but will serve the commercial market as well. These projects, as well as many others intended to modernize the military that are in the pipeline, appear to position Lockheed Martin very well in the future earnings sense.

If indeed Lockheed Martin maintains reasonable earnings progress, and widespread concerns over defense spending are misplaced, then the current share valuation is remarkably low. Based on the 2009 consensus earnings estimate of \$7.41 per share, which includes a substantial negative pension fund earnings impact, and which is in reality a temporary adjustment due entirely to the condition of the equity markets, the shares trade at 11x 2009 estimated earnings, and 9.8x the 2010 consensus estimate. On a cash flow basis, since the company has only modest capital reinvestment requirements, the present \$82 share price represents a 14x multiple on 2010 estimated free cash flow. Historically, these are very low valuation levels. Over the last five years, the shares have traded at an average 17x p/e, which is not inconsistent with the experience of the other defense companies.

There are really two ways in which one may view the current valuation. If, as is widely believed, the current U.S. defense budget is going to be under considerable pressure for the next several years, which would then place considerable pressure on the Lockheed Martin earnings, then the single digit p/e ratio is probably an appropriate reflection of this earnings scenario. If one were to divide the current \$82 share price by the historical 17x p/e, the resultant earnings per share would be \$4.81, which represents a 39% decline from the 2008 level of \$7.86. This implied level of earnings appears to be sufficiently pessimistic, since this suggests a rather draconian reduction in defense spending.

However, the alternative viewpoint is that Lockheed Martin will not suffer an egregious earnings loss scenario. Let us presume that the company produces a 6.7% profit margin, which is the 2010 consensus estimate, and is the historic norm. If revenues increase at a rate of 6.4% per annum, again suggested by the analytical estimates, the company would realize \$3.442 billion of net income in 2011. Let us further presume a reduction to the outstanding share count, as the company has been repurchasing its shares at a rapid rate over the last three years, the most current annualized rate being 4.6% during the 1<sup>st</sup> quarter of 2009. If over the next two years, the company retires 4% of its shares per annum, the 2011 share count would be 358 million, which translates into \$9.61 of estimated earnings per share that year. At a 15x p/e, the share price would be \$144.22 for a 25.5% annualized rate of return, assuming December 2011 as the end point for a 2.5 year time horizon. Inclusive of the 2.9% dividend yield, the total return on investment would be 28.4% per annum. Alternatively, a somewhat lower valuation of perhaps 12.5x earnings would create a \$120.13 share price representing a 19.5% annualized return over 2.5 years.

Obviously, the current valuation presupposes an earnings diminution. If this is not likely to occur, then the Lockheed Martin shares are clearly undervalued. Accordingly, purchase of these shares is recommended.

## **Company Description**

### **Background and The Technology Bubble Experience**

Lockheed Martin, as it currently exists, was formed in 1995 from the merger of Lockheed Corporation and Martin Marietta Corp. Prior to this combination, Lockheed had been one of the leading aircraft manufacturers for the U.S. Department of Defense (DOD) while Martin Marietta was at the forefront of space and missile technology as a contractor for both the DOD and NASA. This transaction in 1995 was one of several defense industry mergers that occurred during the 1990s, as these companies were forced to quickly adapt to a lower procurement budget and altered overall military strategy that followed an end to the Cold War in the early 1990s. Lockheed Martin even attempted to acquire Northrop Grumman in 1998, a transaction which was ultimately denied by the U.S. Dept. of Justice.

Nevertheless, during this time, certain weaponry projects were eliminated since the threat of a large adversary, which was the Soviet Union, had greatly diminished. Focus was placed on other areas of defense, such as prosecuting much smaller potential wars, which requires an entirely different arsenal. Prior to 1990, many of the defense companies were undiversified and relied upon only a few large scale programs. The elimination of any of these programs presented a grave threat to the underlying earnings base. Subsequent to this period of consolidation, new companies were formed that had diversified books of business that were able to withstand shifts, to be distinguished importantly from declines, in government spending.

Given the company's inclination towards space technology, Lockheed Martin also expanded, ultimately unwisely, into telecommunications and other satellite ventures during the Technology Bubble of the late 1990s. Many of these projects were for commercial market customers, who experienced great financial difficulty during the collapse in technology spending that began in 2000. At one point in 1999, Lockheed Martin had amassed \$11.4 billion of debt versus a \$6.4 billion shareholders' equity base. Ergo, beginning in 2000, the company rapidly divested itself of these telecommunication and satellite assets such as COMSAT and Lockheed Martin Intersputnik in an effort to deleverage the balance sheet. Despite this rather painful process that involved over \$2 billion of impairment charges and asset value write-downs during 2000-2002, the company has eliminated \$8 billion of debt since that time, and now maintains a sensibly arranged balance sheet. The restructured Lockheed Martin, as described below, is comprised of assets well funded by both the DOD and NASA spending budgets.

### **Business Segments**

Following the aforementioned restructuring that has occurred over the last five years, the company now operates within the confines of the following four segments.

#### **Electronic Systems**

Within Electronic Systems, the Lockheed Martin products can be further separated into Maritime Systems & Sensors, Missiles & Fire Control, and Platform, Training & Energy. Within the Maritime division, the company produces command control, intelligence, and surveillance capabilities to submarine combat systems, sea-based missile defense systems, and other sea-based equipment. An example of these products would include the Aegis Weapon System, which defends against air, surface, and subsurface threats.

Lockheed Martin is also a leading missile manufacturer, which includes land-based, air, theatre missile defense systems, and other precision-guided weapons and munitions. The PAC-3 is the

company's leading missile product that is accompanied by the Arrowhead firing system, the latter of which provides modernized targeting and piloting capabilities primarily for missiles carried on Apache helicopters.

Lastly, the company develops mission-specific applications for fixed and rotary-winged vehicles as well as tactical wheeled vehicles. Most recently, Lockheed Martin was selected to develop systems for the new Marine One helicopters that will be supplied to the President of the U.S. This program is designed to produce a helicopter that permits the President to perform all duties of the White House while airborne.

In the table below, the recent operating results from the Electronic Systems segment are provided.

**Table 1: Electronic Systems Financial Results**

	1Q09	2008	2007	2006
Revenues	\$2,913	\$11,620	\$11,143	\$10,519
Operating Profit	\$390	\$1,508	\$1,410	\$1,264
Operating %	13.4%	13.0%	12.7%	12.0%

(\$ in millions)

**Information Systems & Global Services (IS&GS)**

The IS&GS business provides federal services, information technology solutions, and advanced technology expertise to a broad spectrum of applications and customers. This is really divided into two categories. First, the company creates systems that gather, process, assimilate, fuse, and distribute data from the ground, air, and space. These communications systems are used by both military personnel as well as civil and commercial customers. For instance, the U.S. Census utilizes certain data collection programs offered by the company, as does the FBI. The military-related systems provide mission and real-time combat command support and warfighter communications.

Following the acquisition of Eagle Group International in 2008, Lockheed Martin also provides infrastructure and administrative support for overseas military bases. This includes staffing, camp construction, democratization, and the management of embassies, air terminals, base camps and other facilities.

The overall revenues and operating income of the IS&GS business is provided in the table below.

**Table 2: IS&GS Financial Results**

	1Q09	2008	2007	2006
Revenues	\$2,761	\$11,611	\$10,213	\$8,990
Operating Profit	\$242	\$1,076	\$949	\$804
Operating %	8.8%	9.3%	9.3%	8.9%

(\$ in millions)

**Aeronautics**

The company manufactures military aircraft that includes combat and air mobility models as well as unmanned aircraft. The major aircraft programs are the F-35 Lightning II Joint Strike Fighter, F-22 Raptor, and the F-16 Fighting Falcon. The F-35 will become the standard stealth fighter jet for all four major branches of the military (Air Force, Marines, Navy, and Army), and will replace the current F-16 model, which has been in production since the 1970s. The F-35 will also be sold to international governments including those of the United Kingdom, Netherlands, Turkey, Australia, Denmark, and Norway. Upon completion of the program, it is expected that the F-35 will not only have enormous U.S. demand, but also considerable demand from U.S. foreign allies as well.

The F-22 has been in production since 1997, and remains a key aircraft for the military, given its stealth, maneuverability, and speed features. Through 2008, a total of 133 aircraft have been produced for the Air Force. Currently, international sales of the F-22 are prohibited by Congress such that the U.S. is the only legal customer of this aircraft. Both the F-35 and F-22 are 5<sup>th</sup> Generation fighter models that allow defense against surface-to-air missiles as well as air-to-air combat.

Apart from fighter jets, Lockheed Martin also manufactures air mobility aircraft, which are designed to provide transport support. The company's C-130 Hercules model is the most prolific of the air transport vehicles, as 257 units have been delivered since production began several years ago. The company also produces the C-5 fleet of airlift aircraft, of which 111 are currently in use by the U.S. military, and which is currently being updated to improve the reliability of the existing models.

Provided below is a table of the Aeronautics segment financial performance over the last three years.

**Table 3: Aeronautics Financial Results**

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	1Q09	2008	2007	2006
Revenues	\$2,781	\$11,473	\$12,203	\$12,188
Operating Profit	\$385	\$1,433	\$1,476	\$1,221
Operating %	13.8%	12.5%	12.1%	10.0%

(\$ in millions)

**Space Systems**

The company has long been one of the leading developers of space technology. This includes satellites, strategic and defensive missile systems, and space transportation vehicles. Within satellites, Lockheed Martin developed the Global Positioning System (GPS), which is currently in redevelopment to improve navigation accuracy and flexibility for military and civil customers. The company also produces the Space-Based Infrared System (SBIRS) that provides the U.S. with missile detection and tracking capabilities.

Lockheed Martin also manufactures a variety of space transportation vehicles such as the Mars Reconnaissance Orbiter and the Mars Phoenix Lander. In addition, the company produces the only non-reusable component of the current Space Shuttle, which is the external fuel tank that is replaced after each launch.



NASA plans to discontinue use of the existing Space Shuttle vehicle in 2010, which will allow the new Lockheed Martin-manufactured Orion to become the next generation human space transportation vehicle. The Orion will begin its first space explorations to the International Space Station in 2011 once the final Space Shuttle missions are completed at the end of 2010.

In the following table, the Space Systems financial results since 2006 are presented.

**Table 4: Space Systems Financial Results**

	1Q09	2008	2007	2006
Revenues	\$1,918	\$8,027	\$8,203	\$7,923
Operating Profit	\$212	\$953	\$856	\$742
Operating %	11.1%	11.9%	10.4%	9.4%

(\$ in millions)

Clearly, Lockheed Martin is broadly diversified across various businesses. During the 1<sup>st</sup> quarter of 2009, the company's revenue attribution was as follows: Electronics Systems 28.1%, IS&GS 26.6%, Aeronautics 26.8%, and Space Systems 18.5%. Nevertheless, it is obviously still dependent on government contracts for the majority of its earnings. During 2008, approximately 84% of the company's sales were generated from the U.S. Government, which includes not only the Dept. of Defense, but also NASA, the FBI, and other agencies. Moreover, about 13% of total sales were attributed to business with foreign governments and militaries, while the balance of 3% was derived from commercial customers.

### **An Historical Tour of the U.S. Defense Spending Budget**

#### *Historical Perspective*

Following World War II, there have been three instances of rapid escalation in U.S. defense spending, all three being during periods of international conflict. For instance, during 1966-1968, which was the peak of the Vietnam War, total U.S. defense spending according to the U.S. Government rose from \$56.6 billion to \$80.4 billion, an increase of 42%. Similarly, during the more dramatic stages of the Cold War, defense spending increased from \$113.6 billion in 1979 to \$265.4 billion in 1986. That the defense budget more than doubled during this eight-year period is an astonishing figure, in light of the historical budget expansion rate of 5.5% per annum, but nevertheless represented the grave concern of a potential war with the Soviet Union during this time. Most recently, following the terrorist attacks of 9/11, defense spending rose from \$290.2 billion in 2001 to \$474.4 billion in 2005 for an increase of 63.5%. These figures are presented in the table below.

**Table 5: Historical U.S. Defense Industry Spending**

Year	Spending Outlay	% Change	Year	Spending Outlay	% Change	Year	Spending Outlay	% Change
1962	\$50,111		1978	\$102,259	7.5%	1994	\$268,579	-3.6%
1963	51,147	2.1%	1979	113,605	11.1%	1995	259,490	-3.4%
1964	52,585	2.8%	1980	130,912	15.2%	1996	253,201	-2.4%
1965	48,780	-7.2%	1981	153,861	17.5%	1997	258,265	2.0%
1966	56,629	16.1%	1982	180,693	17.4%	1998	255,806	-1.0%
1967	70,069	23.7%	1983	204,356	13.1%	1999	261,212	2.1%
1968	80,355	14.7%	1984	220,865	8.1%	2000	281,059	7.6%
1969	80,771	0.5%	1985	245,114	11.0%	2001	290,212	3.3%
1970	80,123	-0.8%	1986	265,443	8.3%	2002	331,871	14.4%
1971	77,497	-3.3%	1987	273,922	3.2%	2003	388,720	17.1%
1972	77,645	0.2%	1988	281,890	2.9%	2004	437,048	12.4%
1973	75,033	-3.4%	1989	294,834	4.6%	2005	474,372	8.5%
1974	77,864	3.8%	1990	289,704	-1.7%	2006	499,357	5.3%
1975	84,852	9.0%	1991	261,866	-9.6%	2007	529,875	6.1%
1976	87,917	3.6%	1992	286,578	9.4%	2008E	583,057	10.0%
1977	95,147	8.2%	1993	278,512	-2.8%	2009E	651,162	11.7%

(\$ in billions)

It will certainly be observed that, over time, the U.S. Government's posture towards defense spending has mostly followed an upward sloping curve, with only moderate spending reductions occurring over this nearly 50-year period. The largest magnitude of decline of -9.6% that occurred in 1991 was somewhat logical, as this followed the end of the great Arms Race with the Soviet Union. As the potential for a large-scale war with the Soviets subsided, the enormous increases in defense spending also ended. Clearly, in the absence of a large adversary, the next several years were ones of rather tepid spending growth. In fact, during the eight years of the Clinton administration, defense spending declined by -8.9%.

Nonetheless, there have been infrequent periods of severe budget reductions. Much of the volatility beyond the 5.5% historical growth rate has occurred during years in which spending rose dramatically, as noted previously.

The logical reason for the absence of large declines is that a majority of the defense budget is essentially fixed. That is, as will be described momentarily, the most substantial portion of the annual budget is dedicated to the wages and healthcare of the military personnel. It is very difficult, in any political environment, to reduce the wages and healthcare benefits of active or reserve soldiers. In addition, the cost of maintaining existing military bases and equipment constitutes roughly one third of the overall budget. Only a relatively small portion of the budget is requested for the expansion or purchase of new defense products. Ergo, even if an increase in the size of the military force has not been desired by the various presidential administrations that



have governed the budget, the cost of maintaining the existing system is demonstrably large, and by that factor alone has tended to produce a positive spending growth rate over time.

However, and very importantly, there are indeed program reductions or eliminations that occur on an annual basis. The nature and locale of U.S. opposition is constantly in a state of evolution. Subsequent to the Cold War, the attention of the military was diverted to the prospect of much smaller wars, and perhaps in more urban surroundings. Variables such as the geographical terrain or battlefield tactics of the enemy ultimately determine the weaponry required for a successful defeat. For instance, for many years, the Army employed traditional all-terrain tanks in both training exercises and during actual combat. Recently, as the conflicts in Iraq and Afghanistan have demonstrated, the prolific use of road-side bombs or improvised explosive devices in these rebellions has rendered these traditional tanks nearly useless for this type of combat. Rapid production is currently underway to produce blast-protected armored vehicles that can not only sustain road-side bomb attacks, but that also can be quickly repaired in the battlefield.

These variances in military tactics ultimately produce variability in the funding of certain defense programs. However, while the annual budget may shift funds to new or existing programs in the reallocation sense, the absolute budget authority rarely declines significantly. In this way, the budgetary money never really leaves the defense system; it merely is reallocated among the various programs as determined by current military needs.

#### *The 2010 Fiscal Year Budget*

According to the Department of Defense, the President's 2010 budget includes \$533.8 billion in base funds for the DOD, and an additional \$130 billion in Overseas Contingency Operations (OCO) for operations in Afghanistan and Iraq. This is an important distinction, in that many observers believe that the Obama administration will hastily withdraw combat operations in these two countries, which, it is presumed incorrectly, would dramatically lower overall U.S. defense spending. Since the Iraq and Afghanistan operations are separate from the ongoing defense budget, it is not entirely clear that even a withdrawal from combat in these regions would greatly impact future defense spending or the appropriations made for projects currently in production by the defense contractors. It may, potentially, negatively impact those non-diversified companies that have been heavily reliant on producing armor-protected vehicles or body armor to defend against the insurgencies, but with respect to the long-term modernization of the military, which is the focus of the Lockheed Martin product pipeline, the funding of the ongoing operations in Iraq and Afghanistan is somewhat irrelevant to the company's longer term earnings picture.

Let us examine the 2010 base budget in greater detail. The current \$533 billion request represents a 4% increase over the 2009 level. There are several ways in which the budget is presented by the DOD so, to begin with, the following table presents spending allocations as classified by functional area.

**Table 6: 2010 U.S. Defense Budget by Functional Area**

<b>Functional Area</b>	<b>Budget Amount</b>	<b>% of Total Budget</b>
Operation & Maintenance	\$185,679	34.8%
Military Personnel	136,016	25.5%
Procurement	107,418	20.1%
Research & Development	78,634	14.7%
Military Construction	20,987	3.9%
Family Housing	1,959	0.4%
Revolving & Mgmt Funds	3,120	0.6%
Total	\$533,813	

(\$ in billions)

In comparison to the total \$533.8 billion projected budget, the largest expenditure relates to the maintenance and operation of the existing military infrastructure, which ranges from administrative military base costs to the expenses of training exercises. As well, the compensation and healthcare benefits of the military personnel exceeds the amount actually deployed towards the procurement of new weaponry and other equipment, which represents 20% of the total budget. If one were to include the R&D budget, which is nearly 15% of the total and relates to defense products that might not reach production for many years, roughly 75% of the total budget is deployed towards costs that are very difficult to reduce.

An alternative, but very similar way to view the budget is presented in the following table. Approximately 35% of the overall budget is appropriated for the modernization of the military, which includes the procurement of new equipment and other tangible assets. This is the portion of the budget that closely resembles the level of spending that will be allocated to projects on which Lockheed Martin bids. The balance of the budget is wage, healthcare, maintenance, operations, and other administrative costs. It is worthy of note that the \$163.9 billion of wage and healthcare costs represents an average of \$51,130 per employee, of which there are 2.3 million active and reserve military personnel. This is certainly not an egregious pay package for the military.

**Table 7: U.S. Defense Budget by Broad Category**

<b>Category</b>	<b>Budget</b>	<b>% of Total</b>
Modernization	\$186.1	34.9%
Military Pay & Healthcare	\$163.9	30.7%
Operations, Readiness, Support	\$160.9	30.1%
Family Housing & Facilities	\$23.0	4.3%
Total	\$533.8	

(\$ in billions)

If one were to include both the base budget and the OCO funding requested for 2010, approximately 32%, or \$210 billion, will be spent on major weaponry systems. Lockheed Martin appears to be well represented in this budget, especially with respect to its aircraft programs. For example, aircraft expenditures of \$53.6 billion are the largest budget item of all the weaponry systems. The company's F-35 program received over \$10 billion of budget authority in 2010, which represents 20% of the total DOD aircraft budgetary authority, and demonstrates the government's commitment to the development of the F-35 program over the next several years.

### **The Lockheed Martin Profitability Characteristics**

#### *Margin Discussion*

An historical discussion of the Lockheed Martin profit experience should be described over two different time periods. That is, prior to 2003, the company was heavily engaged in satellite and telecommunications operations that essentially masked the underlying profitability that is inherent to the defense industry. Moreover, prior to 1995, the company operated on a stand-alone basis, or without the merger efficiencies that were achieved with the Martin Marietta transaction. Lastly, the business known as Level 3 Communications was spun off from Lockheed Martin in 1997, which again altered the margin complexion. Thus, the company's current profit margin should be distinguished from the pre-2003 average for these reasons.

During the 1990-1999 period, the company produced a net margin in the range of 2.9% - 5%. As will be demonstrated shortly, this is well below the level that is generally attainable by defense companies. Given the magnitude of impairment charges that occurred during 2000-2002, which at times caused operating losses, there is little validity in studying this time period in the profit margin sense.

The margin analysis should really commence in 2003, which represented a period of normal operating conditions. In the below table, it is viewed that the company's net margin has risen from 3.3% to 7.5%.

**Table 8: Lockheed Martin Profit Margin, 2003-2008**

<u>Year</u>	<u>Net Margin</u>
2008	7.5%
2007	7.2%
2006	6.4%
2005	4.9%
2004	3.6%
2003	3.3%

The 6% - 9% net margin level is consistent with the entire industry profitability. Due to the bidding process for defense projects, in which the government applies a certain degree of pressure to these companies in order to contain program development costs, it is unlikely that any one

company will realize superior profit margins. In this way, the defense industry profit margin is essentially regulated by the government. This continuity of profitability is presented in the following table.

**Table 9: Defense Industry Profit Margins**

Year	General Dynamics	Northrop Grumman	L-3 Comm.	Raytheon
2008	8.5%	n/m	6.4%	7.2%
2007	7.6%	10.5%	5.4%	8.0%
2006	7.1%	9.2%	4.2%	6.0%
2005	6.9%	8.2%	5.4%	4.9%
2004	6.3%	7.6%	5.5%	2.4%

Lockheed Martin Balance Sheet Discussion

Due to the company's overexpansion into telecommunications, these mostly debt-financed acquisitions created enormous leverage in the balance sheet. For instance, in 1999 total debt of \$11.9 billion exceeded the \$6.4 billion shareholders' equity base by nearly 2x. Declining revenues from the telecommunications ventures placed pressure on the company's profitability, as the debt service requirements were quite high, such that Lockheed Martin was forced to radically restructure its balance sheet through the sale of the telecommunications assets.

Since 1999, debt has been reduced to \$3.8 billion, which will be viewed in relation to the \$2.4 billion of cash on hand. Although the equity base is also lower, due to the unfunded status of the pension fund, which causes a direct reduction to shareholders' equity, the overall net debt-to-capitalization ratio is 21.5%.

It must be noted that the company's pension plan is currently underfunded by a substantial amount. The current pension liability carried on the balance sheet is \$12.3 billion. In 2008, the value of its pension plan assets fell by -32%, as the assets were 85% invested in stocks and bonds, both of which substantially declined in value last year. Ergo, the pension plan, which was about \$900 million underfunded in 2008, suffered a significant loss of value.

While the costs associated with funding the pension plan are income statement events, Lockheed Martin is partially refunded for pension expense through its government contracts. Funding contributions are determined not only by U.S. GAAP policies, but also by U.S. Government Cost Accounting Standards (CAS). Under CAS accounting, a certain portion of pension fund requirements can be recovered and ultimately included in total project cost proposals to the government. For instance, during the 1<sup>st</sup> quarter of 2009, the company recorded \$259 million of pension expense, \$145 million of which was recovered under CAS policies, such that the net expense was \$114 million. Nevertheless, the value of the fund assets will fluctuate annually based on fund performance. Given the near unprecedented declines in asset values that were experienced last year, presumably the funded status of the plan should rise over time, and the unfunded obligation could gradually diminish.

**Valuation**

*Historical Context*

In similarity to the separation of profit margin periods, those being pre and post-2003, one must really be concerned only with the most recent period, as Lockheed Martin was an entirely different company prior to, and during, the Technology Bubble. Towards this end, the average p/e ratio at which the shares traded during the 2003-2007 period was 17.6x. As the share price fell by nearly -30% in 2008, although recovering from the March 2009 low, the valuation over the last two years has been 10x-11x, which reflects the lack of confidence in the company's earnings estimates.

**Table 10: Historical Lockheed Martin P/E Ratio**

Year	P/E
2008	10.7x
2007	14.8x
2006	15.9x
2005	15.5x
2004	19.6x
2003	22.0x

It is somewhat possible to gauge the pre-2003 valuation period through the lens of General Dynamics. In other words, General Dynamics is also an extremely well-managed defense firm that did not engage in telecommunication expansion and, therefore, produced a reliable profit during the Technology Bubble. Over the past decade, as shown below, the General Dynamics valuation has closely resembled the Lockheed Martin level. It might be asserted, then, that in a normal valuation environment, the p/e ratio of a defense company should not be the current 10x-11x, but closer to perhaps 15x.

**Table 11: Historical General Dynamics P/E Ratio**

Year	P/E
2008	9.3x
2007	17.4x
2006	17.7x
2005	15.9x
2004	17.7x
2003	18.1x
2002	15.3x
2001	17.1x
2000	17.4x
1999	12.0x
Avg. 1999- 2007	16.5x

It is also worthy of note that the current valuation predicament of Lockheed Martin is a function of industry sentiment, as opposed to a specific flaw of the company itself. Although the entire equity market collapsed in November 2008, following the election of the current president during this time, the valuations of the defense industry collapsed as well, and have yet to recover. The current p/e ratios of the largest defense companies are presented below.

**Table 12: Defense Industry P/E Ratios**

Company	2010 P/E
Lockheed Martin	9.8x
Raytheon	9.1x
General Dynamics	9.0x
L-3 Comm.	8.8x
Northrop Grumman	8.4x

Return Scenario #1

Lockheed Martin is expected to earn \$7.41 per share this year, or \$2.882 billion of net income. Including the non-cash depreciation and amortization charges of \$808 million, the company's total cash earnings might be \$3.69 billion. In 2008, its capital expenditures were \$926 million, and the current dividend should amount to \$908 million. On a free cash flow basis, the company should earn roughly \$1.856 billion, which results in a 64.4% free cash flow-to-earnings ratio. At the current \$31.8 billion market capitalization, the free cash flow yield is 5.8%.

Importantly, however, the current year earnings estimate includes over \$1 per share of pension expense, which presumably the company will not incur in subsequent years. The 2010 consensus earnings estimate is \$8.34, which serves as a normalized profit level for the company. Hence, the 2010 free cash flow yield, assuming constant variables presented above, is 7%. Stated alternatively, the price/free cash flow multiple in 2010 is 14.4x, which is historically the company's p/e ratio.

If it were assumed that the entirety of estimated free cash flow were used to repurchase shares, as the company indeed has undertaken a substantial share repurchase program, the increase in earnings per share would be 7%. Inclusive of the 2.9% dividend, the going-in rate of return would be nearly 10% per annum.

Return Scenario #2

Lockheed Martin appears, however, to represent more than merely a low double-digit yield vehicle. Let us adopt a 2.5 year time horizon because, presumably, during this time the defense spending posture of the current administration should become evidently clear. If the defense budget were to increase at its historical rate of 5.5% or, rather, not experience a sharp reduction, Lockheed Martin might be presumed capable of realizing its historical growth pattern as well.

The 2010 consensus revenue growth rate estimate is 6.4%. If this rate were applied to the 2010 anticipated revenue level of \$48.28 billion, the company would realize \$51.37 billion of revenues in 2011. The application of a 6.7% net margin, which is the 2010 consensus estimate, and well



within historical parameters, to the \$51.37 billion revenue figure would produce \$3.442 billion of net income.

Over the last five years, Lockheed Martin has retired approximately 11% of its shares outstanding. The current repurchase rate during the 1Q09 was 4.6%. Let us presume that this activity continues, and that the company repurchases 4% of its shares outstanding over the next 2 years. Thus, the estimated share count would be 358 million.

On this basis, Lockheed Martin would earn \$9.61 per share in 2011. In an optimistic scenario in which some degree of valuation restoration occurs, perhaps to a 15x p/e, the share price would be \$144.22. This represents a 28.4% annualized return including the 2.9% dividend yield. Alternatively, presuming a more pessimist valuation scenario, the application of a 12.5x p/e would create a \$120.13 share price for a 19.5% compounded rate of return. All that is required for this level of return is the maintenance of the current profit margin, which should inevitably result in a valuation adjustment.

### **Investment Summary**

The current Lockheed Martin earnings estimates are viewed with particular skepticism. It is believed that the current presidential administration will drastically reduce U.S. defense spending, and that the government's prime contractors, Lockheed Martin being one of those, will suffer an earnings diminution as a result of this policy. However, it has been demonstrated throughout this report that defense appropriations, over time, have consistently risen. Irrespective of the administration's posture towards the current operations in Iraq and Afghanistan, which are entirely separate spending appropriations, it is hard to imagine that the modernization of the military and of U.S. defense systems will cease given the global political environment. If, then, the Lockheed Martin earnings manifest much more stability than is currently envisioned, not only should the company's valuation rise, but the current profit margin should be maintained as well, both of which could lead to extraordinary returns. Accordingly, the shares are recommended for purchase.

Lockheed Martin Corporation  
Unaudited Condensed Consolidated Statement of Earnings

	Quarter Ended	
	March 29, 2009	March 30, 2008
	<i>(In millions, except per share data)</i>	
<b>Net Sales</b>		
Products	\$ 8,468	\$ 8,464
Services	1,905	1,519
	<u>10,373</u>	<u>9,983</u>
<b>Cost of Sales</b>		
Products	7,527	7,523
Services	1,692	1,386
Unallocated Corporate costs	149	5
	<u>9,368</u>	<u>8,914</u>
	1,005	1,069
Other Income (Expense), Net	52	109
<b>Operating Profit</b>	1,057	1,178
Interest Expense	76	87
Other Non-Operating Income (Expense), Net	(3)	(7)
Earnings Before Income Taxes	978	1,084
Income Tax Expense	312	354
<b>Net Earnings</b>	<u>\$ 666</u>	<u>\$ 730</u>
<b>Earnings Per Common Share</b>		
Basic	\$ 1.69	\$ 1.80
Diluted	\$ 1.68	\$ 1.75
<b>Cash dividends declared per common share</b>	\$ 0.57	\$ 0.42

Lockheed Martin Corporation  
Condensed Consolidated Balance Sheet

	(Unaudited) March 29, 2009	December 31, 2008
	(In millions)	
<b>Assets</b>		
Current Assets		
Cash and Cash Equivalents	\$ 2,384	\$ 2,168
Receivables	6,097	5,296
Inventories	1,921	1,902
Deferred Income Taxes	726	755
Other Current Assets	543	562
Total Current Assets	<u>11,671</u>	<u>10,683</u>
Property, Plant and Equipment, Net	4,443	4,488
Goodwill	9,684	9,526
Purchased Intangibles, Net	351	355
Prepaid Pension Asset	126	122
Deferred Income Taxes	4,644	4,651
Other Assets	3,614	3,614
	<u>\$ 34,533</u>	<u>\$ 33,439</u>
<b>Liabilities and Stockholders' Equity</b>		
Current Liabilities		
Accounts Payable	\$ 2,165	\$ 2,030
Customer Advances and Amounts in Excess of Costs Incurred	4,902	4,535
Salaries, Benefits and Payroll Taxes	1,604	1,684
Current Maturities of Long-term Debt	242	242
Other Current Liabilities	2,452	2,051
Total Current Liabilities	<u>11,365</u>	<u>10,542</u>
Long-term Debt, Net	3,563	3,563
Accrued Pension Liabilities	12,267	12,004
Other Postretirement Benefit Liabilities	1,414	1,386
Other Liabilities	3,105	3,079
Total Liabilities	<u>31,714</u>	<u>30,574</u>
Stockholders' Equity		
Common Stock, \$1 Par Value Per Share	386	393
Additional Paid-in Capital	—	—
Retained Earnings	11,583	11,621
Accumulated Other Comprehensive Loss	(9,150)	(9,149)
Total Stockholders' Equity	<u>2,819</u>	<u>2,865</u>
	<u>\$ 34,533</u>	<u>\$ 33,439</u>