THE STAHL REPORT

The Contrarian Series

November 29, 2021

Huntington Ingalls Industries, Inc.

(BUY)

Price: $181.55
52-Week Range: $156.36 - $224.13
Shares Outstanding: 40.3m
Market Capitalization: $7,316m

Ticker: HII
Dividend: $4.56
Yield: 2.5%

Valuations within this text are based on a $193.91 share price

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HORIZON KINETICS

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Investment Thesis

Huntington Ingalls is the largest manufacturer of submarines, aircraft carriers, and assault ships for the U.S. Department of Defense. It was spun out of Northrop Grumman in 2011 to separate the amphibious equipment and weaponry operations from the broader and more diversified defense contracting business of Northrup Grumman. Since then, Huntington Ingalls has made a number of smaller acquisitions in an effort to become the predominant provider of water-based military vehicles for the U.S. Government. Naturally, the Navy and Coast Guard are the two primary customers of this arsenal.

The company has two main shipbuilding yards, one located in Virginia and the other in Mississippi. These are mostly long-duration projects that, in the case of aircraft carriers, can take several years to complete construction. Once placed into service, a typical aircraft carrier can remain in the fleet for approximately 50 years, so the product lifecycle is extremely long. As a consequence, the upgrade of the Naval fleet can take decades to complete.

The valuations of defense companies typically fluctuate based on investors' perceptions of a certain political administration's policy towards national defense spending. The reality is, while annual spending does indeed modestly decline in certain years, the budget for defense is almost always increasing if viewed over longer periods of time (as opposed to the four-year increments of each administration). Irrespective of the interim variations, total defense spending has expanded by 4.6% annually over the last 20 years. Unless there is a fairly dramatic alteration in policy towards national defense and military preparedness, it is hard to imagine that the defense budget is at risk of a severe contraction.

Thus far, Huntington Ingalls has been a remarkably successful spin-off. From 2012, the company's earnings per share have increased by 24.8% per annum, while the share price has provided a 17.8% annual return. This level of profit expansion is clearly unsustainable, and the nearer-term outlook concerning defense spending might not be as robust as in the recent past. In fact, the valuations of the entire defense industry reflect this, as the average price/earnings ratio of these companies is presently 15.1x, a considerable discount to the broad equity market.

Nevertheless, Huntington Ingalls operates in an industry in which the majority of budget spending is allocated to a handful of large platform contractors, and in which continued funding is almost universally considered essential to national security. Even in the current environment, one could achieve a reasonable long-term return from these shares, due in part to the relatively low earnings multiple of 13.6x.

Based on the 2022 consensus earnings estimate, the company might earn $577 million in net profit next year, and $879 million of cash earnings after adding back non-cash depreciation and amortization expense. The company expects capital expenditures to be around 3.5% of sales, so the subtraction of this $394 million would leave $485 million of free cash flow.

The current quarterly dividend payment is $1.14/share, which requires $184 million on an annual basis, and provides a 2.4% yield. This leaves $301 million in remaining free cash flow, or 3.9% of the market capitalization, which could be used to continue the implementation of the share repurchase program. Hence, the implied financial return (dividends and share repurchases) is 6.3%.

There are other points of optionality that would be additive to the return profile. Firstly, the company would need to expand per share earnings by only 3.7% to raise the overall implied return to 10%, which seems more than possible in light of the recent five-year expansion record of 9%.

Secondly, the average P/E recorded since the spin-off has been 16x, an 18% premium to the current earnings multiple. Over the last five years, the Huntington Ingalls shares have underperformed the defense sector by a wide margin (only a 5% cumulative return relative to 30%-50% returns generated by its larger competitors). Despite this, a potential 16x P/E relative to the current S&P 500 valuation would still represent a substantial discount to the stock market.

Attention might also be paid to the company's growing Technical Solutions segment, which will represent 25% of total company revenues next year, following a series of acquisitions completed over the last five years. This is an asset-light business that provides intelligence, digital warfare solutions, and unmanned weapon systems. As an inherently more profitable business that specializes in modern warfare – as opposed to traditional equipment such as planes, tanks, and ships - this operating division could potentially raise the overall margin and valuation profile over time. Therefore, quite unexciting conditions are all that are required to produce a satisfactory return and, as such, the shares are recommended for purchase.

Company Description

Huntington Ingalls operates through three business segments. The first, Ingalls, designs and constructs non-nuclear ships for the Navy and Coast Guard. This facility is located in Pascagoula, Mississippi on 800 acres along the Pascagoula River. Production activities are focused on amphibious assault ships, surface combatants, and national security cutters. The amphibious assault ships and surface combatants are typically either large deck vessels utilized by the Navy and Marines, or guided missile destroyers. The cutters are designed to fulfill the Coast Guard's objective of retiring operationally expensive ships that can conduct missions beyond 50 miles from shoreline. The flagship of this program is the company's Legend class of multi-platform ships, which currently are the only large multi-mission ships in the Coast Guard's fleet.

The second business segment, Newport News, designs and constructs nuclear-powered ships, such as aircraft carriers and submarines. The Newport News shipyard is located on 550 acres along the James River, which adjoins the Chesapeake Bay. Aircraft carriers are the largest ship in the Navy's fleet, each one with a displacement of over 90,000 tons. The company has delivered over 31 carriers to the Navy since 1933, and currently is contracted to provide the next generation Gerald R. Ford class of ships (the first of this new model was delivered in 2017).

Huntington Ingalls constructed the world's first nuclear-powered carrier, the Enterprise, in 1961. Some 52 years later, in 2013, the company secured the contract to inactivate and decommission this ship, which was completed in 2018. Due to the long-duration nature of the building contracts, and the complexities and expertise involved in nuclear power, Huntington Ingalls is the primary beneficiary of government contract awards for these ships.

In fact, General Dynamics is the only other U.S. defense contractor capable of building nuclear-powered submarines. Newport News has delivered 62 submarines to the Navy since 1960, comprised of 48 fast attack and 14 ballistic missile submarines. More recently, these two contractors have formed collaborative partnerships to construct the next generation of submarines. For example, the new Virginia class of fast attack nuclear submarines is a contract partnership between Huntington Ingalls and General Dynamics – the former will produce the stern, machinery spaces, torpedo room, sail, and bow, while the latter will construct the engine room, control room, and pressure hull structure.

The final operating segment, Technical Solutions, is a service-based division that serves the Department of Defense, local and state governments, and private sector companies. The company provides intelligence, surveillance, simulation and training, and cyber operations to U.S. governmental agencies. In addition, it has been expanding its unmanned solutions capabilities by providing customers in over 30 countries with services that include the design, testing, and manufacturing of unmanned underwater and surface vessels.

Lastly, Huntington Ingalls uses its expertise in nuclear power to provide state governments and private companies with decontamination, decommissioning, and hazardous waste management services in relation to various nuclear power plants in operation.

The Technical Solutions division has been the focus of recent acquisitions. Two small companies were purchased in 2020, which preceded the acquisition of Alion Science and Technology Corp. in 2021 for $1.8 billion (a sizeable transaction relative to the Huntington Ingalls market capitalization of $7.8 billion). Alion provides intelligence analytics, reconnaissance, and surveillance services to the Department of Defense and Navy.

It seems clear that the management of Huntington Ingalls is intent on expanding this business further. In 2018, the division provided 11.1% of total company revenues, and 13.5% by 2020. The addition of Alion will raise this contribution to 25.4% of overall revenues. Electronic warfare/defense has become an increasingly important, even, perhaps, the predominant tool in the arsenal of government defense systems and strategy. This is largely a computerized, asset-light approach that reduces the reliance on massive equipment fleets and human engagement. Thus far, the Technical Solutions segment has yet to achieve much operating scale, producing a 2%-3% operating margin over the last three years. However, if expansion through acquisition continues, it is entirely reasonable that profitability could begin to approach the level generated by companies operationally focused on this portion of national defense, suggesting a doubling or tripling of currently recorded profitability.

As shown below, the Newport News business line provides more than half of the company's total revenues. This is entirely logical due to the enormous size of the carrier and submarine programs. The Technical Solutions component, while growing through acquisition, is still the smallest portion of overall revenues.

Table 1: Huntington Ingalls Revenues by Operating Division

	Nine Months Ending Sept. 30						
	2021	2020	*% Change*	2020	2019	2018	*% Change*
Ingalls	$1,947	$1,926	*1.1%*	$2,678	$2,555	$2,607	*2.7%*
Newport News	4,124	3,821	*7.9%*	5,571	5,231	4,796	*16.2%*
Technical Solutions	890	957	*-7.0%*	1,268	1,237	906	*40.0%*
Total	$6,961	$6,704	*3.8%*	$9,517	$9,023	$8,309	*14.5%*

($ in millions)

Along these lines, the table below presents revenues by ship type, which highlights that the most significant contribution is derived from aircraft carriers.

Table 2: Huntington Ingalls Revenues by Ship Type

	2020 Revenues
Ingalls	
Amphibious assault ships	$1,403
Surface combatants/Coast Guard cutters	1,267
Other	8
Newport News	
Aircraft carriers	$3,056
Submarines	1,727
Other	788

($ in millions)

Huntington Ingalls as a Standalone Defense Contractor

Huntington Ingalls was spun out of Northrop Grumman in 2011 as a means for Northrup Grumman to separate its shipbuilding operations from the core aircraft and space assets. Since that time, Huntington Ingalls has expanded revenues at a rate roughly consistent with overall defense industry spending. This spending, while highly publicized, does indeed fluctuate with the prevailing administration in office, but does not vary dramatically in any given year measured. Of course, spending will be impacted by any conflict or war (or the withdrawal therefrom) in which the United States is engaged.

On balance, U.S. defense spending has increased by 4.6% annually since 2001. Much of the large platform program spending is part of multi-year or multi-decade replacement/upgrade cycles that are not necessarily subject to the more discretionary, shorter-duration spending allocations. As merely one example, it will take Huntington Ingalls many years to complete the decommissioning and replacement of the Navy's aircraft carrier fleet, some of which have been in operation since the 1970s.

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Table 3: Historical U.S. Defense Spending

Year	Annual Spending	Year	Annual Spending
2020	$714	2010	$689
2019	676	2009	657
2018	622	2008	612
2017	590	2007	548
2016	585	2006	520
2015	583	2005	494
2014	597	2004	454
2013	626	2003	405
2012	671	2002	349
2011	699	2001	306
Annl'zd %, 5-yr:	5.1%		
Annl'zd %, 10yr:	*0.2%*		
Annl'zd %, 20yr:	*4.6%*		($ in billions)

Not coincidentally, the Huntington Ingalls revenues have advanced by 4.3% since 2012, its first year as a publicly-traded company. As is often the case with spun-off companies, much of the inherent profitability was being masked within the larger parent organization, since corporate spending allocations and growth objectives are determined on a prioritized, centralized basis, as opposed to a more targeted and concentrated approach at the individual operating company or subsidiary level.

This can be evidenced in the margin expansion that occurred at Huntington Ingalls almost immediately following its separation from Northrop Grumman. The operating margin improved from 5.3% in 2012 to a high of 12.4% in 2016. As a result, operating income increased at more than twice the rate of annual revenue growth over the last nine years, and after-tax net income expanded at twice the rate of operating income growth (in part due, of course, to the reduction in corporate income taxes in 2017).

Table 4: Historical Huntington Ingalls Growth, Post-Spin-Off

Year	Revenues	Operating Income	Operating Margin	Net Income
2020	$9,361	$799	8.5%	$696
2019	8,899	736	8.3%	549
2018	8,176	951	11.6%	836
2017	7,441	881	11.8%	479
2016	7,068	876	12.4%	573
2015	7,020	769	11.0%	404
2014	6,957	655	9.4%	338
2013	6,820	512	7.5%	261
2012	6,708	358	5.3%	146
Annl'zd %, 9yrs	*4.3%*	*10.6%*		*21.6%*
Annl'zd %, 5yrs	*7.3%*	*-2.3%*		*5.0%*

Valuation

The large defense companies do not generate much interest among investors at the moment. It is widely believed that total defense spending will not expand under the current political administration, and might actually decline over the next few years. If this is indeed the case, the earnings of these companies would surely be under some degree of pressure.

However, this possibility is already reflected in the valuations of the industry. On average, these companies trade at 15x next year's earnings estimates, a 32% discount to the forward P/E multiple of the S&P 500 – which, of course, is heavily populated by high multiple technology companies.

Table 5: Large Defense Company Valuations

Company	2022 P/E
Raytheon	18.3x
General Dynamics	16.2x
Northrup Grumman	14.6x
Huntington Ingalls	13.6x
Lockheed Martin	12.6x
Average:	*15.1x*

While Huntington Ingalls is near the bottom of the valuation spectrum for this industry, it has achieved superior annualized per share earnings growth since its separation from Northrop Grumman, and nearly double-digit annual profit expansion over the last five years. It is difficult to argue, based purely on fundamental operating performance, that these shares should trade at a relative discount. One could also argue that the 38% discount at which it trades to the S&P 500, in light of the return profile that follows, is also somewhat extreme.

Table 6: Per Share Earnings Growth Comparison

Year	Lockheed Martin	General Dynamics	Huntington Ingalls
2020	$24.50	$11.00	$17.14
2019	21.95	11.98	13.26
2018	17.59	11.22	19.09
2017	6.50	9.77	10.46
2016	12.08	8.64	12.14
2015	11.46	9.08	8.36
2014	11.21	7.83	6.86
2013	9.04	7.03	5.18
2012	8.36	2.73	2.91
Annl'zd %:	*14.4%*	*19.0%*	*24.8%*
5-yr %:	*19.3%*	*6.2%*	*9.0%*

A few additional elements could be pertinent to the valuation discussion at this stage. Over the last five years, the Huntington Ingalls shares have provided only a 5.4% cumulative return. Other companies to which it has just been compared have performed markedly better, with Northrop Grumman producing the highest return of 47% return over this time frame.

Huntington Ingalls, though, is not actually a large cap company based on its $7.8 billion market capitalization. The other large platform defense companies have market capitalizations in excess of $50 billion, which actually could create limitations to the impact future acquisitions could have on the earnings and valuation profiles of these companies. Based on its size, Huntington Ingalls could continue the current expansion/acquisition pattern and produce meaningfully higher earnings over time as a result. Yet, it trades at one of the lowest valuations within the industry. Since this is rather counterintuitive, clearly the market has not factored this into the presently low valuation.

Table 7: Defense Company Share Price Return Comparison

Company	Market Capitalization	Five-year Share Price Return
Northrup Grumman	$57.6B	47.1%
Lockheed Martin	$95.4B	30.2%
Raytheon	$131.3B	27.4%
General Dynamics	$56B	16.6%
Huntington Ingalls	$7.8B	5.4%

A base case return outcome could be outlined as follows. In 2022, the analyst community believes Huntington Ingalls will generate $14.31/share in net earnings, or $577 million of net income. This would become $879 million of cash earnings if the $302 million of non-cash depreciation and amortization were added back. In the company's 3rd quarter 2021 earnings presentation, it indicated that capital expenditures next year would be approximately 3.5% of revenues, which would amount to $394 million. Thus, free cash flow in 2022 might be $485 million.

Of this, $184 million will likely be paid to shareholders in the form of a dividend, representing a yield of 2.4%. This leaves $301 million of cash flow, which is 3.9% of the market capitalization. The company has two primary options here. It could continue the share repurchase program implemented a number of years ago, which has reduced shares outstanding by 17.4% since 2011. Conversely, it could repay debt, though it is not a heavily indebted company. At the end of September 2021, it recorded $555 million in cash, $3.3 billion of debt, and $2.2 billion in shareholders' equity. In either scenario, the implied base return, including dividends, would be 6.3%.

In other words, only 3.7% of earnings growth, all else equal, would be required to generate a 10% annual implied return. At the current rate of inflation, at over 6%, this may be possible merely through inflation-adjusted price increases charged to the Department of Defense (a portion, although not all, of the company's contracts allow for raw material/cost escalators).

Or, if the company could simply reproduce the 5% annual profit growth of the last five years, a return of 11.3% would be possible.

There are a few more forms of optionality. The current earnings multiple of 13.6x is noticeably below the company's history as a public company. Since 2012, the shares have traded at an average of 16x earnings. Were this multiple achieved again in the future, this would account for another 18% share price expansion from the current valuation.

Table 8: Huntington Ingalls Historical P/E Ratio

Year	P/E
2020	9.2x
2019	19.7x
2018	10.8x
2017	22.7x
2016	16.0x
2015	15.3x
2014	17.0x
2013	18.3x
2012	15.2x
Avg.	*16.0x*

To conclude, mention has been made throughout this report of the company's more recent effort to expand the Technical Solutions operating division. Not only is this consistent with the direction of national defense spending – towards asset-light, electronic forms of warfare – but also with a potential improvement in the margin and valuation profile. Currently, the Department of Defense allocates about $36 billion in overall defense spending to information technology-related investments. Since this is still relatively small in relation to the total $700 billion budget, there is clearly sufficient capacity for the electronic warfare-focused companies to increasingly capture more of the budget allocation and, perhaps, expand revenues at a higher rate than the largest companies in this industry.

Table 9: U.S. Dept. of Defense Information Technology Annual Spending

Fiscal Year	Total Dept. of Defense IT Spending
2021	$35.8
2020	35.1
2019	35.2
2018	34.7
2017	33.4
2016	30.6
2015	30.4
2014	31.2
2013	31.9
2012	35.0
2011	34.4

($ in billions)

*Fiscal year ends Sept. 30

Based on the 2022 estimated earnings outcome just presented, Huntington Ingalls will generate a free cash flow margin of 4.3% ($485 million in free cash flow / $11.3 billion in 2022E revenues). While the Technical Solutions segment is still somewhat small and has not yet achieved optimal operating scale, it is worthwhile observing the profitability of one of the leaders in electronic warfare and intelligence, CACI International. This company provides a somewhat similar set of services and consultancy – top secret project guidance performed by high security clearance employees - to the Department of Defense as the growing intelligence/unmanned vehicle business at Huntington Ingalls.

This is not a capital-intensive business requiring ongoing maintenance and expansion expenditures, as is the case in constructing a 90,000 ton nuclear-powered aircraft carrier at a facility of over 500 acres. This is evident in a relative profitability comparison. In CACI's recently completed fiscal year 2021 (ending June 30), it achieved a free cash flow margin of 8.4%, twice the level of the overall Huntington Ingalls margin. It stands to reason that if Technical Solutions continues to expand, representing a larger and larger portion of the total corporate cash flow, the company's operating and free cash flow margin should expand. If this does not improve the valuation profile, a range of options exist, including the potential spin-off of this business – a return to form, of sorts, to the original separation from Northrop Grumman.

Conclusion

Huntington Ingalls is the primary builder of large ships and submarines for the Department of Defense. These include aircraft carriers, submarines, assault ships, and large vessels used by the Coast Guard. It currently trades at nearly a 40% discount to the S&P 500, largely based on the belief that defense spending will decline under the current political administration. While this indeed may be the case, the long-term growth rate in defense spending over the last 20 years has been 4%-5%. The U.S. Naval fleet is currently in the process of being upgraded, which could take decades to complete because of the long-duration nature of these shipbuilding programs, so Huntington Ingalls should likely exhibit a future revenue growth rate that is similar to the expansion in defense industry spending over time. In light of the company's current valuation, only a 13.6x earnings multiple, a low double-digit annual return profile would require only a few percentage points of profit growth over the current free cash flow yield. Accordingly, the shares are recommended for purchase.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (UNAUDITED)

	Three Months Ended September 30		Nine Months Ended September 30	
(in millions, except per share amounts)	**2021**	**2020**	**2021**	**2020**
Sales and service revenues				
Product sales	**$ 1,701**	$ 1,699	**$ 5,185**	$ 4,743
Service revenues	**637**	615	**1,662**	1,861
Sales and service revenues	**2,338**	2,314	**6,847**	6,604
Cost of sales and service revenues				
Cost of product sales	**1,453**	1,388	**4,402**	3,931
Cost of service revenues	**554**	490	**1,450**	1,550
Income from operating investments, net	**11**	6	**31**	19
Other income and gains	**2**	—	**3**	—
General and administrative expenses	**226**	220	**636**	648
Operating income	**118**	222	**393**	494
Other income (expense)				
Interest expense	**(24)**	(27)	**(63)**	(68)
Non-operating retirement benefit	**45**	29	**135**	89
Other, net	**2**	2	**10**	(8)
Earnings before income taxes	**141**	226	**475**	507
Federal and foreign income tax expense (benefit)	**(6)**	4	**51**	60
Net earnings	**$ 147**	$ 222	**$ 424**	$ 447
Basic earnings per share	**$ 3.65**	$ 5.47	**$ 10.52**	$ 11.01
Weighted-average common shares outstanding	**40.3**	40.6	**40.3**	40.6
Diluted earnings per share	**$ 3.65**	$ 5.45	**$ 10.52**	$ 10.98
Weighted-average diluted shares outstanding	**40.3**	40.7	**40.3**	40.7
Dividends declared per share	**$ 1.14**	$ 1.03	**$ 3.42**	$ 3.09

Net earnings from above	**$**	**147**	$	222	**$**	**424**	$	447
Other comprehensive income								
Change in unamortized benefit plan costs		**43**		24		**102**		70
Other		**(1)**		1		**1**		—
Tax expense for items of other comprehensive income		**(11)**		(6)		**(26)**		(18)
Other comprehensive income, net of tax		**31**		19		**77**		52
Comprehensive income	**$**	**178**	$	241	**$**	**501**	$	499

HUNTINGTON INGALLS INDUSTRIES, INC.
CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL POSITION (UNAUDITED)

($ in millions)	September 30, 2021	December 31, 2020
Assets		
Current Assets		
Cash and cash equivalents	**$ 555**	$ 512
Accounts receivable, net of allowance for doubtful accounts of $2 million as of 2021 and 2020	**446**	397
Contract assets	**1,363**	1,049
Inventoried costs, net	**143**	137
Income taxes receivable	**221**	171
Assets held for sale	**—**	133
Prepaid expenses and other current assets	**66**	45
Total current assets	**2,794**	2,444
Property, plant, and equipment, net of accumulated depreciation of $2,105 million as of 2021 and $2,024 million as of 2020	**3,043**	2,978
Operating lease assets	**246**	192
Goodwill	**2,684**	1,617
Other intangible assets, net of accumulated amortization of $702 million as of 2021 and $655 million as of 2020	**1,187**	512
Deferred tax assets	**10**	133
Miscellaneous other assets	**436**	281
Total assets	**$ 10,400**	$ 8,157
Liabilities and Stockholders' Equity		
Current Liabilities		
Trade accounts payable	**$ 508**	$ 460
Accrued employees' compensation	**367**	293
Current portion of postretirement plan liabilities	**131**	133
Current portion of workers' compensation liabilities	**231**	225
Contract liabilities	**674**	585
Liabilities held for sale	**—**	68
Other current liabilities	**533**	462
Total current liabilities	**2,444**	2,226

Long-term debt	**3,321**	1,686
Pension plan liabilities	**833**	960
Other postretirement plan liabilities	**379**	401
Workers' compensation liabilities	**522**	511
Long-term operating lease liabilities	**198**	157
Deferred tax liabilities	**154**	—
Other long-term liabilities	**360**	315
Total liabilities	**8,211**	6,256
Commitments and Contingencies (Note 14)		
Stockholders' Equity		
Common stock, $0.01 par value; 150 million shares authorized; 53.4 million shares issued and 40.1 million shares outstanding as of September 30, 2021, and 53.3 million shares issued and 40.5 million shares outstanding as of December 31, 2020	**1**	1
Additional paid-in capital	**1,984**	1,972
Retained earnings	**3,819**	3,533
Treasury stock	**(2,145)**	(2,058)
Accumulated other comprehensive loss	**(1,470)**	(1,547)
Total stockholders' equity	**2,189**	1,901
Total liabilities and stockholders' equity	**$ 10,400**	$ 8,157

This report was produced by Horizon Kinetics ("HK"). The following persons employed by HK contributed to this report: Murray Stahl, Chairman, Steven Bregman, President, and Peter Doyle, Managing Director. HK is located at 470 Park Avenue South, New York, NY 10016. At the time of this report, there are no planned updates to the recommendations. To the extend HK has provided previous recommendations concerning the same issuer(s) during the preceding 12-month period, such recommendations do not differ from the recommendations contained here.

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