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General Dynamics Corp. (GD)

Q2 2017 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to the General Dynamics Second Quarter 2017 Earnings Conference Call. All participants will be in listen-only mode. [Operator Instructions] Please note this event is being recorded.

I would now like to turn the conference over to Alison Harbrecht, Staff Vice President of Investor Relations. Please go ahead.

Alison Harbrecht

Staff Vice President, Investor Relations, General Dynamics Corp.

Thank you, Amy, and good morning, everyone. Welcome to the General Dynamics second quarter 2017 conference call.

Any forward-looking statements made today represent our estimates regarding the company's outlook. These estimates are subject to some risks and uncertainties. Additional information regarding these factors is contained in the company's 10-K and 10-Q filings.

With that, I would like to turn the call over to our Chairman and Chief Executive Officer, Phebe Novakovic.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

Good morning. As you can discern from our press release, we enjoyed a solid second quarter, with revenue of \$7.68 billion and net earnings of \$749 million. We reported EPS of \$2.45 per diluted share, \$0.15 a share better than the year ago quarter and \$0.02 per share better than consensus.

With respect to consensus, it would appear that the sell side anticipated somewhat more revenue, but lower margins and a somewhat higher tax rate. Operating earnings were about as forecast by the sell side. All in all, pretty close.

Compared to the year ago quarter, revenue of \$7.68 billion was \$99 million or 1.3% lower. However, net earnings of \$749 million were up \$35 million or 4.9%, on a 60 basis point improvement in operating margins and 160 basis point lower effective tax rate. This led to EPS that was 6.5% better than the year ago quarter. Sequentially, revenue was up \$234 million or 3.1% and operating earnings were up \$21 million or 2%, on a 10 basis point lower operating margin, still very respectable 13.8%.

Let me turn briefly to the first half of 2017 compared to the first half of 2016. Revenue was down \$134 million, less than 1% against the first half of 2016. On the other hand, operating earnings were up \$140 million or 7.2% on lower cost. Operating margins were 100 basis points better. Earnings from continuing operations were up \$144 million or 10.5%. EPS was \$0.55 better.

In short, we had a very good first half, somewhat ahead of both our internal plan and external expectations, and well ahead of last year. This leads quite naturally to the guidance increase reflected in the press release. I'll provide additional color on that guidance in a minute.

But first, let me give you some perspective on the segment reporting for the quarter and for the half. I'll then conclude with some comments on the outlook for each segment for the remainder of the year and wrap that into our EPS guidance.

First, Aerospace. Aerospace had a very good quarter in all important respects. Revenue of \$2.08 billion was \$206 million lower than the year ago quarter. However, operating earnings of \$425 million or \$1 million more, on 190 basis point improvement in operating margin. On a sequential basis, revenue was up \$4 million and operating earnings were down \$18 million, on a 90 basis point reduction in margin, but remaining in excess of 20%.

For the first half, revenue at \$4.15 billion is up \$87 million against last year. Importantly, operating earnings at \$868 million are up \$112 million or 14.8%, on a 230 basis point improvement in margin. In short, at \$868 million in operating earnings for the first half of the year, Aerospace is well positioned to achieve its earning goals for the year.

By the way, recall we previously told you that the new revenue recognition rule which helped us in the first two quarters of the year would have a negative impact in the second half, particularly in the fourth quarter. So expect lower operating margins in the second half, especially in the fourth quarter. You'll see this reflected in our guidance.

Let me give you some commentary about order activity in the quarter and then some observations about the current state of the market, insofar as it impacts Gulfstream. First, in the quarter, the dollar-based book-to-bill was 0.9 to 1, which is very good. The mix is particularly advantageous, with over 80% of the orders for large-cabin aircraft. The G500 and G600 continued to build backlog in advance of their entry into service, sufficient to ensure the success of these programs, interestingly, the G550 built backlog as well in the quarter.

While we read the reports of weak demand and reduced deliveries across the industry, our experience is reasonable and steady demand for our products. We will deliver as many airplanes this year as we did last on an entry-into-service basis.

Commentators frequently speak of weakness in the large-cabin market. Let me say that it is misleading to speak of a highly differentiated marketplace as if it were one market. Parts of the market are very active, particularly those market segments where there is new product. There are also market segments that are slow, largely because of the absence of product introduction. So we believe that the market is not only differentiated by segment, but also by the innovative offerings within this segment. We believe this is why demand for our products remain fairly consistent.

We are comfortable with the anticipated third quarter orders based on early contract activity and contract discussion. The interest in the G650 and G650ER as well as the G550 remains quite good and supportive of next year's operating plan. In short, we expect a good third quarter and a second half from an orders perspective.

Now, let me say a few words about our progress towards certification of the G500 and G600. The G500 and G600 flying continues to go well. The aircraft are performing reliably and on schedule. The G500 testing includes four test aircraft and one production aircraft with a full interior. The four test aircraft have entered the Type Inspection Authorization or TIA flying phase. This phase is for actual certification credit. FAA pilots have joined Gulfstream flight crews on these TIA tests. We continue to work collaboratively with the FAA to ensure optimal safety and efficient use of resources.

We expect to complete certification flying in Q4 2017. Additionally, we continue to work closely with our suppliers to complete all component level testing this year. Once we have completed certification, the interior test aircraft, P1, will enter service as our G500 demonstrator. It is important to note, however, that the G500 will not have any impact to revenue and earnings this year. That is the result of the new revenue recognition rule. The G600 now has four test aircraft flying and the interior is being installed in the first production aircraft. We remain on schedule to certify in 2018.

Let's now turn to the defense side of the house. First, Combat Systems. Combat had a very good quarter as the relevant comparisons clearly indicate. Revenue of \$1.41 billion was \$117 million more than the second quarter last year, up 9%. Similarly, operating earnings were \$225 million, up \$20 million, almost 10% better than second quarter 2016. On a sequential basis, the story is similar. Revenue was up \$127 million or almost 10%, and operating earnings were up \$20 million, again, almost 10% better.

For the first half, revenue was up \$159 million or 6.3% against the first half of 2016. Operating earnings were up \$38 million, 9.7% on a 50 basis point margin expansion. Our U.S.-based programs continue to perform well across our platforms, ordnance and ammunition portfolios. We continue to move nicely from engineering to production on our two large international orders. We also continue to win programs particularly out of our European Land Systems business. We are obviously trending in the right direction at Combat Systems.

With respect to the Marine group, revenue of \$2.08 billion was \$101 million higher than Q2 a year ago. Operating earnings were up \$6 million against the year-ago quarter. On a sequential basis, revenue was up \$145 million and operating earnings were up \$17 million on the higher revenue and a 30 basis point improvement in operating margin. For the first half, revenue of \$4.01 billion was down \$87 million or 2.1% against the first half of 2016. Operating earnings were also lower by \$17 million on a 30 basis points contraction in margin.

Work on our submarine programs, that is production on Blocks 3 and 4 for the Virginia-class and engineering on the Columbia ballistic missile submarine replacement, continue to perform nicely. With respect to our Bath shipyard, the challenges on the DDG 1000 and 51 restart ships are largely behind us, and our auxiliary ship and commercial businesses continued smoothly. In addition, we have seen an uptick in demand for repair across our repair yards, primarily in San Diego and Washington State. Marine Systems has been a compelling growth story for us and will continue to be so. Our operating margin should continue to improve over time.

Turning to IS&T, the group continues to perform well on the bottom line, despite some revenue headwind. Revenue of \$2.1 billion was down \$111 million against the year ago quarter. On the other hand, operating earnings of \$240 million were up against the year ago quarter by \$6 million. There was an 80 basis point improvement in operating margin, which was particularly impressive.

Sequentially, revenue was lower by \$42 million or 2%, but operating earnings were up \$4 million on a 40 basis point improvement in margin. This quarter's 11.4% operating margin is exceptional in my view.

The story for the first half is much the same. Revenue was down \$293 million or 6.4%, but operating earnings were up \$5 million on an 80 basis point improvement in margins. So once again, very strong operating leverage. For both our IT services and tactical communication and Intel business, our cost performance and market positioning have driven very nice win rates. Not surprisingly, our IS&T backlog grew \$175 million in the quarter, with a book-to-bill of greater than 1 to 1 once again. In short, we believe the segment results leave us positioned to do well in the second half.

Before I move on, let me give you a sense of the defense environment, at least from my perspective. There is clear intent in the administration and in parts of the Congress for increased defense spending. We believe this intent will manifest in some level of increased defense spending in the procurement and R&D accounts.

The question is how much and when? Relevant considerations include: the dispatch with which Congress approves a higher defense budget and how soon the administration can propose and the Congress can approve the department's senior leadership appointment. Without these appointments, it is difficult to process contracts and get authorized and appropriated funds obligated to contracts. At this juncture, both are proceeding more slowly than we thought would happen. Nevertheless, we remain confident in the direction of defense spending.

So turning to guidance, let me provide some guidance for the year for each segment, compare it to what we told you in January and then wrap it up into our EPS outlook.

For Aerospace, our guidance was to expect revenue of \$8.3 billion to \$8.4 billion, up 6.4% from 2016; operating earnings of approximately \$1.6 billion, with an operating margin rate of 19.1% to 19.2%. We now expect to be approximately \$8.1 billion of revenue, with margins of 19.5% to 19.6%. This implies pressure on margins in the second half, particularly in the fourth quarter. This will result in no change to the operating earnings forecast, still a very strong industry-leading performance.

For Combat, our previous guidance was to expect revenue to be up 6.6% to 6.7% over 2016, with operating earnings of \$920 million to \$925 million. We now expect revenue of somewhat over \$5.9 billion, just slightly above the 7% growth over last year, and operating earnings of \$925 million to \$930 million. So pretty close to the original guidance, with a slight upward bias.

For the Marine group, we've previously guided to revenue of \$7.9 billion, margins at around 8.6% and operating earnings of \$680 million to \$685 million. We now expect revenue to be up another \$160 million to \$165 million, with margins consistent with the previous forecast, resulting in a modest improvement in operating earnings.

For IS&T, we guided to revenue up modestly over 2016, operating earnings of \$1 billion to \$1.05 billion, with a margin rate of around 11%. It now appears that our revenue forecast is essentially flat and that operating earnings will be somewhat better at about 11.2% to 11.4%.

So all of this rolls up into revenue for General Dynamics of about \$31 billion and operating margins of 13.3% to 13.5% – 13.4% to 13.5%. Compared to our initial guidance, we will have somewhat lower revenue, operating earnings at the higher end of the forecasted range, a somewhat lower tax rate and a lower share count, which permits us to increase our EPS guidance to \$9.70 to \$9.75.

To help you further, our EPS guidance was \$9.50 to \$9.55. The \$0.20 difference is \$0.05 from operations, \$0.05 to \$0.06 from a lower tax rate and about \$0.09 to \$0.10 from share purchases. The EPS progression for the remainder of the year is down slightly in Q3 versus Q2, with Q4 looking similar to this quarter.

I'd now like to turn the call over to our CFO, Jason Aiken.

Jason W. Aiken

Chief Financial Officer & Senior Vice President, General Dynamics Corp.

Thank you, Phebe, and good morning. Our net interest expense in the quarter was \$24 million versus \$23 million in the second quarter of 2016. That brings the interest expense for the first half of the year to \$49 million versus

\$45 million for the same period in 2016. The increase in 2017 is due to a \$500 million increase in our outstanding debt last year. For 2017, we expect interest expense to be approximately \$105 million.

Our effective tax rate was 27.4% for the quarter and 26% year-to-date. As Phebe mentioned, we're lowering our target for the full year to a rate of 27.5%. That reflects a greater benefit associated with employee stock option exercises than originally anticipated.

On the capital deployment front, in the second quarter, we repurchased 2.7 million shares, bringing us to 4.6 million shares in the first half of the year for \$900 million. In total, when combined with the dividends we paid, through the first six months of 2017, we've spent \$1.4 billion in shareholder-friendly capital deployment, more than 1.5 times our \$857 million of free cash flow for the first half.

This left us at the end of the quarter with a cash balance of \$1.9 billion and a net debt position of \$2.1 billion. We continue to anticipate free cash flow this year to approximate 100% of net earnings and, in turn, deploying 100% of that free cash flow to share repurchases and dividends.

Alison, that concludes my remarks, and I'll turn it back over to you for the Q&A.

Alison Harbrecht

Staff Vice President, Investor Relations, General Dynamics Corp.

Thanks, Jason. As a reminder, we ask participants to ask only one question so that everyone has a chance to participate. If you have additional questions, please get back into the queue. Amy, can you please remind participants how to enter the queue?

QUESTION AND ANSWER SECTION

Operator: Certainly. [Operator Instructions] The first question comes from Ronald Epstein, Bank of America Merrill Lynch.

Ronald J. Epstein

Analyst, Bank of America Merrill Lynch

Hi, good morning, Phebe and Jason.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

Hi, Ron.

Jason W. Aiken

Chief Financial Officer & Senior Vice President, General Dynamics Corp.

Good morning.

Ronald J. Epstein

Analyst, Bank of America Merrill Lynch

Maybe just a big picture question for you, Phebe, in terms of the Land Systems business. We've seen a lot more press lately on the Russian T-14 Armata tank. When you look at the Land Systems business and you kind of look

into the tea leaves, is there an opportunity there for you guys in terms of some sort of equipment response from the U.S. in terms of either yet another upgrade to the Abrams or something new, if you can add any color there.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

Yes. So the U.S. Army is anticipating upgrading the Abrams to the next version, in part to meet the changing and evolving threat, frankly, worldwide. So we have factored a lot of that into our thinking. And if you think about it, we went from one tank production a month for several years, just keeping that plant on my support and we're now looking at nice, nice improvement and throughput for that plant. So we see demand increasing for the Abrams in various configurations, both domestically and outside the U.S. as well. So the Abrams is, I think, positioned quite well to do – to continue to grow.

Ronald J. Epstein

Analyst, Bank of America Merrill Lynch

Q

Okay. Great. Thank you.

Operator: The next question is from Samuel Pearlstein, Wells Fargo.

Samuel J. Pearlstein

Analyst, Wells Fargo Securities LLC

Q

Good morning.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

Hi, Sam.

Samuel J. Pearlstein

Analyst, Wells Fargo Securities LLC

Q

I was wondering if you could talk a little bit about, IS&T has been running down for the first half of the year, if I just look last year, it's little bit of a tough comparison, you're still expecting to get to flat. I mean, how do you get there? What do you need to win or what's happening with IS&T in terms of being able to get to growth in the second half of the year?

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

So let's talk about that in two respects. First, both of these businesses are shorter-cycle businesses and they're more affected by an extended CR. Recall, we had a seven-month extended CR, which had a impact on our products business and the execution of obligated funds, execution of appropriated funds in terms of obligation. So that's pretty much a question of timing as the military services gear back up on their execution.

The second side is on our services business. We had very slow execution on programs in several civilian agencies, primarily driven by uncertainty and, in some cases, reduction in funding levels. I suspect some of that we'll obtain through the course of the year until the administration sorts out some of the funding for some of the civilian agencies. But that said, we believe that our products business is poised for growth for the remainder of the year. Recall, we have a very nice backlog in this business, so it's simply a question of timing, when our customers execute programs.

Samuel J. Pearlstein

Analyst, Wells Fargo Securities LLC

Thank you.

Q

Operator: The next question is from David Strauss at UBS.

David E. Strauss

Analyst, UBS Securities LLC

Hey, good morning, Phebe, Jason, Alison.

Q

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

Hi.

A

David E. Strauss

Analyst, UBS Securities LLC

Wanted to ask on cash flow. I think, Jason, you comment that you're still targeting 100% free cash flow conversion for the year, through the first half a little weaker than I expected. Can you just talk about what's going on there? The billed and unbilled receivables, and does that stabilize through the rest of the year or partially reverse, and what exactly is driving that? Thanks.

Q

Jason W. Aiken

Chief Financial Officer & Senior Vice President, General Dynamics Corp.

Sure. I guess at a macro level, what we've seen through the first half of the year is really on par with what we planned for the year, so nothing out of the ordinary. We expected a bit of a ramp to the second half. So as I mentioned, still targeting at or around 100% conversion.

A

The build-up in working capital, you mentioned was actually anticipated in connection with the Land Systems' international programs. Really what we're seeing there is as we're moving from what we experienced in the past couple of years with large advance payments and then the burn down of those advance payments, which we've talked about ad nauseam at this point.

As we move into production, you're seeing a more typical build-up of the unbilled receivables prior to delivery. And as we then move into a ramp up of deliveries, we'll begin to liquidate that unbilled receivables and we expect to see that to start to turn in the second half, and hence, a bit more of the ramp in the cash flow in the second half. So all part and parcel of moving from the development phase of that contract into production and a subsequent ramp in deliveries. So we'll see that unwind beginning in the second half.

David E. Strauss

Analyst, UBS Securities LLC

Thank you.

Q

Operator: The next question is from Doug Harned at Bernstein.

Douglas Stuart Harned

Analyst, Sanford C. Bernstein & Co. LLC

Good morning. Thank you.

Q

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

Good morning.

A

Douglas Stuart Harned

Analyst, Sanford C. Bernstein & Co. LLC

On Gulfstream, Phebe, you've talked in the past about your pipeline being very strong, and I think you're reiterating that today. But one of the things that you've raised is the fact that it's been a little slower converting interest into firm orders. Could you give us a sense from the discussions you're having, and I would say both in the U.S. and abroad, with customers, are there things that are slowing them down, in other words, are they looking for signals, economic signals, you had mentioned Brexit a while back when that happened, what are you seeing holding people back?

Q

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

Nothing. Actually, no substantive issue in particular, simply more rigor as they move into the contracting process. So I don't see any macro reasons. We have identified none that we've got potential customers who are waiting on the sidelines, it's simply just taking longer for a whole series of reasons. Everything from the introduction of brokers to additional board approvals, so for fleet aircraft purchases. Those are constant, but there's nothing in particular that's driving this other than I think this is just a new regular order. It's going to just take longer from the time you enter the pipeline to the time you sign the contract.

A

Douglas Stuart Harned

Analyst, Sanford C. Bernstein & Co. LLC

And presumably, your transition to the new models, I would think would be a part of this too?

Q

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

Yes. I don't think that there's anything particular about those new models that would change the length of time that we're experiencing. I think that's a structural change. It's simply around timing. It's taking a bit longer, and we've learned to adjust to it.

A

Douglas Stuart Harned

Analyst, Sanford C. Bernstein & Co. LLC

Okay, very good. Thank you.

Q

Operator: The next question is from Myles Walton at Deutsche Bank.

Myles Alexander Walton

Analyst, Deutsche Bank Securities, Inc.

Thanks, good morning.

Q

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

Hi.

Myles Alexander Walton

Analyst, Deutsche Bank Securities, Inc.

Q

I was hoping to follow-up on Gulfstream. I think, Phebe, you mentioned that there'd be no G500 deliveries in 2017. I thought there was going to be one. And then also the sales guidance ticking down, is that the slippage of a few deliveries, or is that just the G500 and maybe used aircraft in isolation?

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

Well, there are a couple of things that are affecting the revenue. We anticipate lower – now, we anticipate lower pre-owned, that carries with it, with a lower pre-owned sales that reduces revenue, but increases margin. We have a few – fewer G450 deliveries and then just lots of other puts and takes.

Myles Alexander Walton

Analyst, Deutsche Bank Securities, Inc.

Q

Nothing on the certification, EIS [indiscernible] (27:01)?

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

No, no, we're good with that. We're on track. The certification and flight test program is proceeding very, very well. And Jason can give you just a little bit more color on the – this really is the essence of the change of the impact of revenue recognition.

Jason W. Aiken

Chief Financial Officer & Senior Vice President, General Dynamics Corp.

A

Sure. I mean, we had talked about for a while dating back entry into service this year, and that's still, as Phebe pointed out in her remarks, the demonstrator aircraft will enter service this year. So we'll complete certification, get type certification, enter that aircraft into service, but that, of course, won't have a revenue implication, that's what she was referring to in her remarks. But nothing otherwise off-schedule or off-plan from what we had anticipated this year.

Myles Alexander Walton

Analyst, Deutsche Bank Securities, Inc.

Q

Got it. Thank you.

Operator: The next question is from Robert Spingarn at Credit Suisse.

Robert M. Spingarn

Analyst, Credit Suisse Securities (USA) LLC

Q

Hi. Good morning.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

Good morning.

Robert M. Spingam

Analyst, Credit Suisse Securities (USA) LLC

Q

Just sticking with Aerospace and Gulfstream, you still – despite the sequential downtick, the margins are still excellent, and I would think that mix is trending away from some of the more mature programs, and so how – Phebe, where would you say the G650 margins are today relative to G450, G550 at peak maturity? How much more runway do you have there to offset the mix of the new aircraft as they come in? And then will there be any margin support at some point from reduced R&D or you're going to keep that level?

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

So the G650 margins have exceeded the G450 and G550 at their peak. And you ask a question that I ask Gulfstream frequently, how much better can we do? And we will do better, the quantum of which we'll have to see. But we've come down our learning curve. That purpose-built facility has turned out to be an operating [ph] mix-up (29:10) for us.

It's been really nice fit for our guys to be able to get sequential airplane-over-airplane improvement. So I suspect we have more to go. You're never done in the continuous improvement. The R&D, you can anticipate our R&D spending to be about the same level. We have a very robust R&D pipeline, product pipeline, so obviously, [ph] that is that (29:38).

Robert M. Spingam

Analyst, Credit Suisse Securities (USA) LLC

Q

Thank you.

Operator: The next question is from Cai von Rumohr at Cowen.

Cai von Rumohr

Analyst, Cowen & Co. LLC

Q

Yes. Thank you very much, Phebe. So GD always has kind of prided itself on focus on return of capital. With stock prices moving up and your own moving up, reducing the leverage of stock repurchase, at what point does it make sense to shift the focus from repurchase to M&A?

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

Well, when attractive, accretive and strategically important target cross our path. So that heretofore has yet to happen. But nonetheless, we don't really comment on this as you well know, but we're certainly not – we're certainly predisposed to be interested should our criteria be met.

Cai von Rumohr

Analyst, Cowen & Co. LLC

Q

Thank you.

Operator: The next question is from Jason Gursky at Citi.

Jason Gursky

Analyst, Citigroup Global Markets, Inc.

Q

Hey, good morning, everyone. Phebe, I was wondering if we could spend a few minutes back on Marine and have you talk a little bit about your view of the world on undersea unmanned, kind of what that market looks like and what do you think GD's strategy might be and maybe what some of the challenges are in that market? And then maybe just to add on some comments here at the end about the demand out at NASSCO with Jones Act and the LNG products that you can produce out there, kind of what the pipeline looks like for those ships? Thank you.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

Sure, sure. So as you well know, we are fully embedded in the undersea warfare element of the Navy's shipbuilding budget. We are – we've been very encouraged to see the Navy's interest in additional SSN Virginia-class. I think they increased recently their shipbuilding plan by 18 SSNs, that's about a 38% increase from 48 to 66, consist of Virginia-class. So that would be very, very encouraging, if that comes to pass. We will see.

We're positioning ourselves, as you all know, for the Columbia ballistic missile submarine. The design is going extremely well, and we're on track to begin the build process exactly when we thought we would. So we see the undersea deterrent and the undersea war-fighting capability of the U.S. Navy as a key national security imperative as clearly evidenced by the Navy's interest in increasing subs.

With respect to NASSCO, interesting to speculate for a moment, NASSCO has continued to perform very, very well. We have the potential for an additional ESB, I think that would be ESB 6. That's a program formerly known as MLP. And we'll see if that comes to pass. We also have – the Navy's given us long-lead funding for the second oiler, and there's an opportunity to accelerate that program to two ships a year, should the Navy so choose. But frankly, all of this takes money, so we're going to have to see how the budget process shakes out and what programs receive what funding and when.

Operator: The next question comes from Howard Rubel at Jefferies.

Howard A. Rubel

Analyst, Jefferies & Co.

Q

Hi, thank you very much.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

Hi, Howard.

Howard A. Rubel

Analyst, Jefferies & Co.

Q

So you've got a whole host of opportunities in front of you, Phebe, and two sort of stand out. One is there's a lot of FMS deals that have been announced, but not yet contracted, and then the G550 platform clearly has a number of military applications that range from domestic to international. Could you put a fence around it or bracket some of this and help us a little bit with timing?

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

So on the FMS, for those programs that flow through FMS, we expect Kuwaiti tanks and tanks for the Kingdom in the fourth quarter. The tanks for the Kingdom have already received Congressional approval. Primarily, we see the FMS used for tanks, less so on the wheeled vehicle side. We also see FMS for our munitions and armaments business, and that has been proceeding quite nicely, not in the big ticket items that the tanks represent, but nonetheless nice steady volume.

With respect to the G550, the G550 is, as I'm sure you know, in service in a number of non-U.S. Air Forces in the ISR mission. And by the way, when we talk about special mission, we mean the ISR mission and we mean Medevac primarily. So – but on the ISR front, the G550 has been in service in some cases for many years in a couple of countries and performed extremely well.

To the extent that there are opportunities for the G550 in the U.S. Air Force market, the Air Force will tell you – tell us if they want our airplane. They don't, they don't. We're – Air Force programs, we're not that intimate with the Air Force, so I tend to defer any questions on the big Air Force programs to the prime. But with respect to the G550, I think it stands on its own merit.

I think there are also some opportunities moving away from the ISR front if you look at the U.S. Air Force and some potential opportunities to refresh some of the executive transport airplanes. But that is a longer-term potential program. I would note that a number of the airplanes are getting a little old in the Air Force executive transportation fleet. So that's again their call and we'll be prepared to respond to whatever their requirements are of us.

Howard A. Rubel

Analyst, Jefferies & Co.

Q

Thank you very much.

Operator: The next question is from Seth Seifman at JPMorgan.

Seth M. Seifman

Analyst, JPMorgan Securities LLC

Q

Thanks very much and good morning. Phebe, I wondered if you could talk to us about the review of WIN-T that General Milley is undertaking and the decision by Senate authorizers to reduce funding and kind of how you see the future of the program from here?

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

Sure. The Army, as it's been widely reported, reviewing its networking and communication strategy, including, but not limited to, WIN-T. And as you can well imagine, we're working very closely with our customers to respond to any changing requirements. And those will play out over time to the extent that there are any. We don't see any significant risk, by the way, in this year to our WIN-T estimate. To give you just a little bit more color, we have a long-standing, 20-year, networking expertise in land forces – tactical land forces network, and we think that positions us very well to work with our Army customer now and in the future.

Seth M. Seifman

Analyst, JPMorgan Securities LLC

Great. Thank you.

Q

Operator: The next question is from Peter Arment at Baird.

Peter J. Arment

Analyst, Robert W. Baird & Co., Inc.

Yes, good morning, Phebe, Jason.

Q

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

Good morning.

A

Peter J. Arment

Analyst, Robert W. Baird & Co., Inc.

Phebe, on Aerospace in particular, I guess, it's been a while since we've talked about Jet Aviation. Maybe you could just give us an update on how that business is doing and is it growing, and what are the prospects you're seeing out there for that?

Q

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

Yes. So Jet Aviation is doing quite well. Their services businesses are up, again, primarily driven by increased flying hours. And their completion revenue and earnings are down a bit due in part to reduced inductions from Bombardier and St. Louis, but we're doing very well in Basel on our completions programs as we transition from engineering to production on several airplanes. So Jet Aviation, both on its services side and its completions side, continues to perform very nicely.

A

Operator: The next question is from Robert Stallard at Vertical Research.

Robert Stallard

Analyst, Vertical Research Partners LLC

Thanks very much. Good morning.

Q

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

Good morning.

A

Robert Stallard

Analyst, Vertical Research Partners LLC

Phebe, in your commentary, you mentioned that the margin in IS&T was exceptional in the quarter. Does this imply that you don't expect this level of return to be sustained over the medium to long term?

Q

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

No, I think I meant exceptional in the sense that it was noteworthy, not that it was rare. As I think we're guiding you to margins in the 11.3% to 11.4% range. I anticipate that we will have no trouble in meeting that spot on. I don't expect any upside beyond that. But these businesses have performed very, very well. Our attention to cost, schedule and performance has really driven the bottom line in both those services business and the products business and communications networking and Intel.

Robert Stallard

Analyst, Vertical Research Partners LLC

Q

That's great, thank you.

Operator: The next question is from Hunter Keay at Wolfe Research.

Hunter K. Keay

Analyst, Wolfe Research LLC

Q

Hi, thank you. Can you hear me?

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

Yes.

Hunter K. Keay

Analyst, Wolfe Research LLC

Q

Great, thanks. Phebe, a little more on G650, can you comment on how you're thinking about rate there in the next year given the comment on strong demand and how the sales effort for the ER conversions are progressing? And then maybe to that a little more, can you talk about the margin profile on the ER variant, is that really a whole lot different than the non-ER model? Thank you so much.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

Well, I'll take the questions in inverse order. I'm not going to parse the differences in margins between the G650 and the G650ER. But as we've been talking about for some time, G650 production is going to come down somewhat in each of the next three years. We increased the production to help us in this transition period as we move from the G450 to the G500 in particular. And so our expectation, the balancing that we've been doing this year and into next is that as the G650 revenue begins to decline, the G500 and G600 will offset that decline. I might note that the interest in the G650 and G650ER continue to be quite robust. In this quarter, we had the highest number of orders that we've had in the last six quarters for the G650 and G650ER. So that airplane continues to generate an awful lot of interest in the marketplace.

Hunter K. Keay

Analyst, Wolfe Research LLC

Q

So there's no thoughts in maybe pushing out the rate cut?

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

Pushing up the rate?

Hunter K. Keay

Analyst, Wolfe Research LLC

Q

No, pushing out the rate cut, putting it off?

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

No. I think that as we look at where the G500 is in terms of orders and our production schedule on the G500, we're comfortable that we can offset the somewhat reduced G650 sales. But I think that's just prudent business.

Hunter K. Keay

Analyst, Wolfe Research LLC

Q

Okay. Thank you so much.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

Thanks.

Operator: The next question is from Peter Skibitski at Drexel Hamilton.

Peter John Skibitski

Analyst, Drexel Hamilton LLC

Q

Good morning, guys. Hey, Phebe, I was wondering if you can go further on your thoughts on the fiscal 2018 defense budget just in terms of the markups and the signals you're getting out of Congress, it still seems a bit muddled over there, especially on the Senate side. And I'm wondering if you see a good path to getting – to eventually getting a budget that's above the President's request or it's just too fuzzy right now?

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

Well, if you go back a number of years, I think we used to have insights into the defense budget process, both within any given administration and on Capitol Hill that weren't necessarily widely shared or available. But given the ubiquitous amount of information that flows today, I think you all know as much as I do in terms of specificity. But the President's budget exceeded – the budget request exceeded the budget caps by \$54 billion; OCO, the Overseas Contingency fund has often acted as a relief valve for the caps.

So perhaps, Congress will consider doing something like that in addition to being able to [ph] can never (43:56) adjust those caps. Both the Senate and House Authorization Bills are significantly in excess of the President's budget. And the House Defense Appropriations Committee is about \$135 billion, I think, over the President's request.

So look, what does all that mean? Right now, it's a giant fur ball and we're going to have to work through the process and see what comes out the other side. As I noted, I believe that there is real interest and desire in

additional defense spending which will manifest itself in some more additional funding and budget for defense. It's just a question of how much and what accounts and when. So we still have ways to work through this process.

Peter John Skibitski

Analyst, Drexel Hamilton LLC

Thank you very much.

Q

Alison Harbrecht

Staff Vice President, Investor Relations, General Dynamics Corp.

Amy, I think we have time for one more question.

A

Operator: The final question is from George Shapiro at Shapiro Research.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

Hi, George.

A

George D. Shapiro

Analyst, Shapiro Research LLC

Hi, Phebe. Typical question for you. If you look at the Gulfstream margin in Q3 and assume it's like it was maybe this quarter, it implies the fourth quarter has got to really drop to 16% or so to get to your guidance. And if you're not going to deliver a G500 in the fourth quarter, so what happens in Q4 to get that big contraction in the margin?

Q

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

I'll let Jason attack that one.

A

Jason W. Aiken

Chief Financial Officer & Senior Vice President, General Dynamics Corp.

George, I mean, obviously, we can try to reconcile the math, I don't think ours is worked out exactly as yours is suggesting. That's probably not totally unusual. But I think the two bigger issues are a little bit of a downtick in the number of deliveries in the fourth quarter. We've talked about that as it relates to outfitted deliveries under the new standard versus our old revenue recognition model. So that is baked into plan. And then it's somewhat bit of a mix there. So more significantly the volume of deliveries, there's a little bit of mix issue affecting the margin. But I don't think it's down quite as dramatically as you're suggesting. It is definitely off as implied in Phebe's guidance.

A

George D. Shapiro

Analyst, Shapiro Research LLC

But let me follow-up, Jason, I mean, you said deliveries for this year would be about equal to last year and the first half is pretty close to the first half of last year. So the Q3 delivery is then going to be a lot bigger and the Q4 one is down, or how does deliveries going to spread out over Q3 and Q4?

Q

Jason W. Aiken

Chief Financial Officer & Senior Vice President, General Dynamics Corp.

A

Yeah. I don't have the Q3 in front of me, directly, I do know that Q4 is off a little bit. I also know that last year was particularly lumpy. The second quarter was a bit of a spike. So we can parse through the quarterly deliveries, but 4Q is definitely off slightly and that's what's the largest impact driving the margin difference.

George D. Shapiro

Analyst, Shapiro Research LLC

Okay. Thanks a lot.

Q

Jason W. Aiken

Chief Financial Officer & Senior Vice President, General Dynamics Corp.

You're welcome.

A

Alison Harbrecht

Staff Vice President, Investor Relations, General Dynamics Corp.

Thank you for joining our call today. If you have additional questions, I can be reached at 703-876-3311. Have a great day.

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