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# General Dynamics Corp. (GD)

Q3 2017 Earnings Call

## CORPORATE PARTICIPANTS

**William A. Moss**

*Vice President & Controller, General Dynamics Corp.*

**Jason W. Aiken**

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

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## OTHER PARTICIPANTS

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*Analyst, Credit Suisse Securities (USA) LLC*

**Seth M. Seifman**

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**Ronald J. Epstein**

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**Myles Alexander Walton**

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## MANAGEMENT DISCUSSION SECTION

**Operator:** Good morning and welcome to the General Dynamics Third Quarter 2017 Earnings Conference Call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions]

Please note that this event is being recorded.

At this time, I would like to turn the conference over to Bill Moss, Vice President and Controller. Please go ahead, sir.

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### William A. Moss

*Vice President & Controller, General Dynamics Corp.*

Thank you, Denise, and good morning, everyone. Welcome to the General Dynamics Third Quarter 2017 Conference Call. Any forward-looking statements made today represent our estimates regarding the company's outlook. These estimates are subject to some risk 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 Senior Vice President and Chief Financial Officer, Jason Aiken.

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### Jason W. Aiken

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

Thanks, Bill, and good morning. I'd like to start by sharing with everyone that Phebe is not able to be here today as she was unfortunately hit with a bad case of the flu. She's asked me to cover today's call, and I've invited our Controller, Bill Moss, to join me. We all wish Phebe a full and speedy recovery. But for now, let's get on with the results.

As is apparent from our press release, we enjoyed another strong quarter. We reported EPS from continuing operations of \$2.52 per fully diluted share on revenue of \$7.58 billion; operating earnings of \$1.052 billion; and income from continuing operations of \$764 million, a 10.1% return on sales. The EPS performance was \$0.16 better than the year ago quarter and \$0.09 better than consensus. Against the year ago quarter, revenue was down \$77 million, or 1%, but operating earnings were up \$37 million, a 3.6% increase; and income from continuing operations was up \$33 million, a 4.5% increase. The quarter's operating margin at 13.9% is 60 basis points better than the third quarter of 2016. Once again, we enjoyed very positive operating leverage.

Sequentially, revenue was down \$95 million, or 1.2%, while operating earnings were down \$4 million and operating margin was up 10 basis points. From an operating perspective, the second and third quarters look a lot alike as we said they would. The \$0.07 EPS improvement was driven by a modestly lower share count and a 180-basis point lower effective tax rate in the third quarter. On a year-to-date basis, revenue was off \$211 million, less than 1%. However, operating earnings are up \$177 million, or 6%, and operating margins are up 90 basis points. Importantly, earnings from continuing operations are also up \$177 million, or 8.4%; and earnings per share from continuing operations are up \$0.71, 10.5% better year-to-date.

With respect to cash, we had very efficient conversion in the quarter. We had net cash provided by operating activities of \$871 million and free cash flow from operations of \$751 million. For the year-to-date, we have cash flow from operations slightly in excess of \$1.6 billion.

As you can see from the charts attached to our press release, an important story in the quarter was the very healthy backlog increase. The total backlog of \$63.9 billion is a \$5.4 billion increase, in excess of 9% over the second quarter. There was very good contract activity in all of our groups, with particularly strong order intake in the Marine group. I should point out that each of our defense businesses enjoyed backlog growth, with the exception of NASSCO, and it didn't miss by much.

Let me say a few words about each of our business groups, and I'll start with Aerospace. Aerospace had another solid quarter. Revenue was up \$70 million, or 3.6%, compared to the third quarter of 2016; and operating earnings increased \$8 million, or 2.1%, to \$385 million on an operating margin of 19.3%. On a sequential basis, the group experienced \$83 million less in revenue, about 4%, and a \$40 million reduction in operating earnings attributable to a 120-basis point contraction in margins. On a year-to-date basis, revenue was up \$157 million, or 2.6%; and operating earnings are up \$120 million, or 10.6%, on a 150-basis point improvement in operating margin.

We had good order intake in the quarter for the group of 0.8 to 1 book to bill measured on a dollar value of orders basis. But Gulfstream alone was a 0.9 to 1 book to bill on both a dollar value and a number of units basis. I can also tell you that our pipeline and active sale discussions are quite good. We're, again, reasonably optimistic about our order intake in the fourth quarter and I expect it to look much like the third quarter, if not somewhat better.

Our certification flying continues to progress well, including the additional test points required to extend the G500 and G600 range. As we announced during the recent NBAA Air show, additional testing has enabled us to increase the G500 range by 200 nautical miles at 0.85 mach and 600 nautical miles at 0.90 mach. It's really quite remarkable that the G500, with a 5200-nautical mile range at 0.85 mach, can travel 4400 nautical miles at 0.90. This was the approximate range of the G450 at 0.80 mach.

On the G600, our additional validation tests have proven an additional 300 nautical miles at 0.85 mach as well as 300 nautical miles at 0.90 mach. The additional testing required for the specific fuel consumption and center of gravity test points have ensured proper performance and safety margins in both aircraft. Although this lengthened the program schedule, we believe the resultant value to our customers was worth the effort.

While flying has progressed on schedule, testing by one of our suppliers for component level qualification associated with the concurrent FAA and EASA certification has added a new complexity at the end of the program. While we accounted for this type of supplier impact in our plan, one of our suppliers apparently didn't anticipate the additional EASA test requirements and is somewhat behind. We expect to resolve this issue and deliver the G500 to our customers as planned. If you recall, when we announced the G500 and G600 in 2014, our plan was to deliver in 2018 and 2019, respectively. So we're still on track and we continue to monitor the supplier closely as we near the end of the certification program.

Turning to Combat Systems, the group had an excellent quarter with revenue of \$1.5 billion, operating earnings of \$247 million, and a really strong 16.5% operating margin. As you would expect, the quarter-over-quarter, sequential, and year-to-date comparisons are all quite favorable. Compared to third quarter of 2016, revenue was up \$173 million, or 13%, and earnings were up \$38 million, or 18.2%, on an 80-basis point improvement in margin. On a sequential basis, revenue was up \$86 million, or 6.1%, and operating earnings were up \$22 million,

or 9.8%, on a 60-basis point improvement in operating margin. Year-to-date, revenue was up over 2016 by \$332 million, or 8.6%. Operating earnings are up \$76 million, or 12.6%, on a 60-basis point improvement in operating margin.

Combat Systems remains on course for a very good year. We fully anticipate that the fourth quarter will see around a 15% increase in revenue over this quarter, but also some degradation in operating margin as a result of a mix shift to new programs, so that the increase in operating earnings will be more modest than the revenue increase. All of our major programs are performing very well. We continue to see opportunities for growth both internationally and domestically for the group.

The Marine group reported revenue of \$1.93 billion, a \$144 million or 6.9% decrease compared to the year ago quarter. Similarly, revenue was down sequentially by \$148 million, or 7.1%, and year-to-date revenue of \$5.94 billion was lower by \$231 million, or 3.7%. Revenue across the year has been down based on Virginia-class Block III timing, a slowdown in the Columbia program design work as a result of extended negotiations over the IPPD contract, and the wind down of some of the commercial work at NASSCO. These revenue headwinds are now largely behind us.

Operating earnings for the third quarter, that's \$179 million, were down by \$18 million compared to last year's quarter. On a sequential basis, the group's operating margins improved 70 basis points, which led to a \$1 million increase in operating earnings despite the \$148 million decrease in revenue. It's very nice to have margins in the group north of 9% once again. While this is encouraging, we'll have to see whether it's sustainable.

And finally, IS&T. While IS&T's revenue at \$2.15 billion was down \$176 million or 7.6% against last year's quarter, it was up \$50 million sequentially. Year-to-date revenue of \$6.4 billion is down \$469 million or 6.8% over last year. However, we expect a strong fourth quarter and we'll be especially flat with 2016 for the year. Revenue has been lower during the year primarily on timing. Lower than expected army product sales impacted the third quarter and the Army had trouble executing after the six-month CR and, of course, the change in administration slowed some execution as well. We'll recover a lot of this revenue in the fourth quarter but don't have enough time to recover at all. Some anticipated revenue will slip into next year, but we're in a good position to hold 2017 revenue close to the 2016 level.

In sharp contrast, operating earnings of \$253 million were up \$14 million, or 5.9%, compared to the third quarter of last year on the strength of a 140-basis point improvement in operating margins. Sequentially, the story is much the same. Operating earnings were up \$13 million (sic) [\$14 million] (10:43) or 11.7% operating margins, which is a 30-basis point improvement. Similarly, year-to-date operating earnings are up \$19 million, a 2.7% increase, on a 110-basis point improvement in the operating margins. So IS&T has managed to overcome less than anticipated revenue with very strong operating performance.

So what does all this mean as far as the next quarter and the year are concerned? We fully expect the fourth quarter to look much like the other three from an operating earnings perspective. However, we expect a higher effective tax rate in the quarter, leading to a lower reported EPS. For the year, stronger than expected operating results year-to-date, a lower than planned tax rate, and a modestly lower share count enable us to increase guidance for the year by \$0.05. Our guidance for EPS from continuing operations now goes to a range from \$9.75 to \$9.80. This late in the year, we anticipate our end of year guidance to be pretty close to actual performance, so the range is narrow.

And finally, in closing, as tempting as it is at this time of year to ask about next year, let me remind you that we have our planning process later this fall, when the businesses get better insight into the upcoming year. The

guidance that we gave you last January was grounded in that process and, as a result, was full and thorough. So I don't want to prematurely piecemeal next year at this juncture. You'll hear from us in detail in January, as has been our custom for many years.

I'd now like to turn the call back to Bill to cover some additional financial items.

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**William A. Moss**

*Vice President & Controller, General Dynamics Corp.*

Thank you, Jason. Our net interest expense in the quarter was \$27 million versus \$23 million in the third quarter of 2016. That brings net interest expense year-to-date to \$76 million versus \$68 million for the same period in 2016. The increase in 2017 is due to a \$500 million increase in our outstanding debt in the third quarter last year. For 2017, we expect interest expense to be approximately \$110 million, which includes the impact of the issuance of \$1 billion of debt in the third quarter in anticipation of the repayment of \$900 million in notes maturing in the fourth quarter. Our effective tax rate was 25.6% for the quarter and 25.8% year-to-date. We're lowering our target for the full year to a rate of approximately 27%. The lower rate in the quarter and our reduced forecast for the year are both attributable to the finalization of open tax years and a greater benefit from employee stock option exercises than previously forecast.

On the capital deployment front, in the third quarter we purchased 1.2 million shares, bringing us to 5.9 million shares in the first nine months of 2017 for \$1.1 billion. In total, when combined with the dividends we paid through the first nine months, we've spent \$1.9 billion or nearly 120% of our free cash flow year-to-date. We've also made a number of small acquisitions in our aerospace and IS&T groups this year totaling \$364 million. This left us at the end of the quarter with a cash balance of \$2.7 billion and a net debt position of \$2.2 billion. We continue to anticipate free cash flow this year to approach 100% of earnings from continuing operations, and will continue to deploy 100% of that free cash flow, less the amount spent on acquisitions, to dividends and share repurchases.

With that, we will move to the Q&A. 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 return to the queue. Denise, could you please remind participants how to enter the queue?

## QUESTION AND ANSWER SECTION

**Operator:** I would be happy to, sir. [Operator Instructions] And the first question will come from Jason Gursky of Citi. Please go ahead.

Jason Gursky  
*Analyst, Citigroup Global Markets, Inc.*

Q

Good morning, Jason and everyone else.

Jason W. Aiken  
*Chief Financial Officer & Senior Vice President, General Dynamics Corp.*

A

Good Morning.

Jason Gursky  
*Analyst, Citigroup Global Markets, Inc.*

Q

Wondering if you wouldn't – going into a little bit more detail on the supplier issue on the G500 and just kind of let us know whether this is a sole-source kind of position for this supplier or maybe a little bit more color on what kind of part this might be. And more specifically even on 2018, kind of when in the year you expect at this point for deliveries to make and whether you'll continue kind of plugging along on production at this point so that expectations around deliveries for the full year of 2018 are kind of no different than where we were, say, back in July during the last earnings call? Thanks.

Jason W. Aiken  
*Chief Financial Officer & Senior Vice President, General Dynamics Corp.*

A

Sure. So first off, I'm really not at liberty to get into any specifics around the specific supplier. That's somewhat confidential information that Gulfstream needs to deal with. But I can tell you that this is not an issue that has to do with anything related to flight tests or the flying capabilities or the readiness of the airplane to go into service. This is strictly a paperwork exercise that we're going through and, really, it has to do with, as we've noted, the additional test points that have allowed the additional range as well as I mentioned the simultaneous – this is the first time we've done a simultaneous FAA and EASA – that's the European Aviation Authority (sic) [European Aviation Safety Agency] (16:19) – certification. And really, that is a benefit to our customers, to achieve those simultaneous certifications so that we can accommodate the deliveries to our international customers. But long story short, this is not any type of risk item to the program. It's strictly a matter of getting through paperwork through that certification process.

As it relates to 2018, as I mentioned, deliveries are still on schedule with our original plan and our original contractual customer dates. You may recall that for a while there we were optimistically considering that there might be an opportunity to advance that entry into service by three or four months. We had this opportunity to go after additional capability in the aircraft, and we did that knowing that we would still be able to meet our original customer commitments while achieving that additional capability. So really, no impact there. And likewise to your question, no impact on our expected 2018 delivery. The production and the delivery schedule remain intact as we originally anticipated, and so we don't see any modification there.

Jason Gursky  
*Analyst, Citigroup Global Markets, Inc.*

Q

Great. Thank you.

**Operator:** The next question will come from Rob Spingarn of Credit Suisse. Please go ahead.

Robert M. Spingarn  
*Analyst, Credit Suisse Securities (USA) LLC*

Q

Good morning.

Jason W. Aiken  
*Chief Financial Officer & Senior Vice President, General Dynamics Corp.*

A

Good morning.

Robert M. Spingarn  
*Analyst, Credit Suisse Securities (USA) LLC*

Q

So Jason, I wanted to ask you about Marine. You talked a little bit about the nice uptick in the backlog there. And at the very end of the quarter, I think you took in a big Columbia order and then two destroyers, one Flight II and one Flight III. I'm curious how much risk you see and the impact on margins from this AMDR Flight III Destroyer, and in the margin profile on Columbia as we go forward here. It may not matter that much this year. I know you don't want to get into 2018, but I'm interested in the margin progression given that these destroyers are fixed-price incentive fee contracts and that we're bringing in this Columbia work.

Jason W. Aiken  
*Chief Financial Officer & Senior Vice President, General Dynamics Corp.*

A

Yeah. So as we've talked about, and I think you hit on it, the Columbia I think is the primary driver that we'll see, if for no other reason, just the volume impact it has as we continue to grow in the Marine Systems group throughout the balance of the decade. And as we've talked about, it is a development cost-plus type contract, so it will come at relatively lower margins that will continue to have a modest dilutive effect for the group. So that's no different I think than what we've talked about up to this point. It's good to have that contract in place so we can keep moving forward, but the margin impact is consistent with what we've talked about historically.

Robert M. Spingarn  
*Analyst, Credit Suisse Securities (USA) LLC*

Q

Jason, is there a way to quantify the mix of Columbia as a percentage of Marine as we go forward here?

Jason W. Aiken  
*Chief Financial Officer & Senior Vice President, General Dynamics Corp.*

A

I don't have that in front of me. What I can tell you is that the growth profile that we laid out, which, really, we anticipated being off a little bit this year in volume and then picking up in 2018 and beyond until the end of the decade, the growth profile, if you follow that CAGR, is almost entirely attributable to Columbia. And it's essentially this design work. So you can put some orders of magnitude on it around there as it relates to the growth of the business and those relatively diluted margins.

Robert M. Spingarn

*Analyst, Credit Suisse Securities (USA) LLC*

Okay. And then just Flight III versus II. It's something that we think about as being higher risk.

Q

Jason W. Aiken

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

Yeah. So it's obviously a relatively significant change to the platform, with the additional radar capabilities. But we feel like we got to a place with the customer where we balanced the need to meet their requirements with the maturity of our design, and it's a balanced risk and opportunity situation. We feel very comfortable with the estimate we've put forth and we wouldn't have put a bid in if we didn't think we could do that. So we're still coming out of, as we've long talked about, some of the issues we had at Bath Iron Works with the four-year production break on the DDG-51 Destroyer line. So we feel very good about the progress they've made. We've got to keep watching that and making progress to see that it's sustainable, but we see this as fitting in very nicely to that book of business. I think we have seven destroyers in backlog at this point of the DDG-51 variety, and we think this is very wholesome for Bath Iron Works.

A

Robert M. Spingarn

*Analyst, Credit Suisse Securities (USA) LLC*

So you can hold margins as you transition on that program?

Q

Jason W. Aiken

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

I have every reason to believe that, yes.

A

Robert M. Spingarn

*Analyst, Credit Suisse Securities (USA) LLC*

Great. Thank you very much.

Q

**Operator:** The next question will come from Seth Seifman of JPMorgan. Please go ahead.

Seth M. Seifman

*Analyst, JPMorgan Securities LLC*

Thanks very much and good morning.

Q

Jason W. Aiken

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

Good morning.

A

Seth M. Seifman

*Analyst, JPMorgan Securities LLC*

Just to follow-up on the G500 question from earlier. I appreciate that you guys are on plan with regard to the original target entry into service date. A year ago on the call the company talked about the G500 making a significant contribution. I assume that meant to EBIT in 2018. Is that still the case?

Q

Jason W. Aiken

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

A

Absolutely. Nothing has come off that. And so recall, there's been a lot of discussion around, is EIS going to be at the end of 2017, beginning of 2018 – we were talking about EIS as a demonstrator model because of the demand requirements that our sales organization was having. And so there's been a lot of back-and-forth over when is the first unit going to be there and what's that going to look like. But fundamentally, two things. With the new revenue recognition protocol, that was never going to be a big impact on 2017, hence the more significant impact in 2018 that we described. And as I said at the outset in the earlier question, the production and delivery schedule we're still adhering to and are on track for. So continue to see 500 ramp-up in 2018 as having a meaningful impact as we draw down. We'll deliver the last 450 in January of next year. We'll continue to draw down the 550 and we'll start to feather out a couple of 650s. So the 500 is a major contributor among those factors.

Seth M. Seifman

*Analyst, JPMorgan Securities LLC*

Q

Great. And then Jason, maybe if you could just describe the acquisitions that you made, kind of what they are and how much they're contributing.

Jason W. Aiken

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

A

Sure. So we've had a number over the year. They've been mostly small in nature. The more recent one was a business in our IS&T group, really out of our IT services business. And it specializes in mission support for the intelligence community, so it fits right in our core as it relates to the GDIT services and a growth market for us. It closed right near the end of the third quarter, in mid to late September, so not really much of an impact. In fact, no really impact at all in the third quarter but we'll expect to see that to start to contribute in the fourth quarter and beyond. The other acquisitions were a couple of small aerospace services business and another mission computing business that we acquired earlier in the year at smaller amounts.

Seth M. Seifman

*Analyst, JPMorgan Securities LLC*

Q

Okay. Thank you very much.

Jason W. Aiken

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

A

Sure.

**Operator:** The next question will come from Rob Epstein (sic) [Ron Epstein] of Bank of America Merrill Lynch. Please go ahead.

Ronald J. Epstein

*Analyst, Bank of America Merrill Lynch*

Q

Yeah. Hey, guys. Good morning, Jason.

Jason W. Aiken

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

A

Hey. Good morning.

Ronald J. Epstein

*Analyst, Bank of America Merrill Lynch*

Q

Just maybe a bigger question for you. When you look at the balance sheet of the corporation, right, you guys are really not very levered at all. And when you think about the efficiency of the balance sheet, is there more you could be doing with it?

Jason W. Aiken

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

A

We've spoken for some time about the fact that, A, we don't have a target balance sheet leverage position; we really are more focused on a couple of things. Number one is maintaining the balance sheet firepower that we have for strategic opportunities that will enable long-term growth. So with the free cash flow we have and the balance sheet capacity that we've had, we've been able to do things like invest in capital facilities, invest in product development across the portfolio, Gulfstream, now Electric Boat in the facility. As well as of course deploy meaningful amounts of capital; in this case, primarily to shareholders in the form of dividends and the share repurchase.

I think as we look forward, a couple of things. We like our credit rating, where we stand today, and we don't look to modify that. But certainly, we see the balance sheet as an opportunity for when and if strategic opportunities come up, that we are ready to be agile and move quickly with those opportunities. You saw that in a small dose here in the first nine months. That's a little bit more of a toe in the water compared to where we've been for the past few years. Where that leads us, we'll see. It really is all about continuing to find accretive opportunities that are in our core, and that's really never changed. That's always been the case and that really is what we hold that balance sheet firepower for.

Ronald J. Epstein

*Analyst, Bank of America Merrill Lynch*

Q

And is it safe to assume if there aren't accretive opportunities that come along that you guys are interested in, you would pick up the return to shareholders either through the dividend or the buyback?

Jason W. Aiken

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

A

So we'll continue to evaluate that on an annual basis. Right now, that continues to be our cadence through the balance of the year. I'm sure you've heard Phebe talk about priorities on capital deployment, that the dividend should be predictable and repeatable and sustainable, so we'll look to continue that. And share repurchase, of course, as always, we do not view that as a strategy. It's been a tactical approach to how we deploy capital, and we'll continue to frankly take it that way. So I think no real change that I foresee in that regard.

Ronald J. Epstein

*Analyst, Bank of America Merrill Lynch*

Q

Okay. Great. Thank you.

**Operator:** The next question will come from Cai von Rumohr of Cowen & Company. Please go ahead.

Cai von Rumohr

*Analyst, Cowen & Company, LLC*

Q

Yes, thank you very much. So if you're late, there've been some rumors that the G500 might not deliver until midyear. Do you expect to deliver in the first quarter still? And if there is an additional delay, what kind of impact do you expect that to have on cash? And lastly, your competitor, the 5X at Falcon, clearly has had another extended delay. Do you expect or have you seen any pickup in orders as a result of that? Thanks.

Jason W. Aiken

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

A

So I don't know of anything about the 500 delay until midyear. Like I said, we remain on track for deliveries in the early part of 2018. So rumors are rumors. I don't necessarily want to speak to that kind of speculation but we remain on track with our contractual delivery timing. And so as it relates to further delays, it would also be, I think, somewhat speculative. I don't know what that would look like, and frankly don't anticipate them, so I don't see an impact to cash or otherwise associated. We are on track and feel good about our ability to close on the certification and get the airplane into service in accordance with our original contractual commitments.

As it relates to competition, we tend not to speculate about them or gauge our performance based on what others are doing. It's fair to say over the past couple of years that we have been the beneficiary of taking some share in this market. It's not something we focus on; it's just a fact. But obviously, if they continue to have issues, if others continue to have issues, we'll continue to do our best to perform and be as competitive as we can be in this market.

Cai von Rumohr

*Analyst, Cowen & Company, LLC*

Q

Thanks so much.

Jason W. Aiken

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

A

Absolutely.

**Operator:** The next question will be from Myles Walton of Deutsche Bank. Please go ahead.

Myles Alexander Walton

*Analyst, Deutsche Bank Securities, Inc.*

Q

Thanks. Good morning.

Jason W. Aiken

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

A

Good morning, Myles.

Myles Alexander Walton

*Analyst, Deutsche Bank Securities, Inc.*

Q

Just part one on cash flow, if I could. I think you mentioned that cash flow return in the form dividends and share repurchase would be 100%, but now it would be 100% after your spend on acquisitions, which I think is a nuance to your price. I'm asking you to just confirm that. And secondly, on the cash flow in the quarter and the full year, did you do the pension contribution in 3Q and what in particular is going to allow you to get to 100% for the full year in 4Q? Thanks.

Jason W. Aiken

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

A

Sure. So on the first question, you read that correctly. It may be a subtlety that we're articulating because it's relevant in the moment, but it's always been our approach that, with respect to capital deployment, I mentioned a minute ago the dividend approach, that steady and repeatable M&A is there if and when we find accretive and core acquisitions, and then the residual from a tactical standpoint is share repurchase. So I don't think that's any different than what we've talked about; it's just that they've become relevant as you've seen it here in the third quarter of this year. So that is absolutely the case. As it relates to pension, we did make our scheduled pension contribution so no change to the outlook. With respect to that, for the year I believe the number was somewhere in the ballpark of \$200 million. I don't think that's changed.

And as it relates to closing out the year, we've got a big fourth quarter lined up but frankly that's not unusual for us. It's a pretty typical pattern for us. And one of the things we, I think, would look to as the biggest driver behind the ramp there in the fourth quarter is the transition to billing and delivery and collection on these major international programs is starting to unwind a good bit of that working capital in the fourth quarter. That's the single biggest driver that brings us down that curve.

Myles Alexander Walton

*Analyst, Deutsche Bank Securities, Inc.*

Q

Okay. And just to clarify. So if M&A continues to be a few \$100 million at a time though, that's actually subtractive from the 100% return and the balance sheet kind of just gets preserved in terms of the leverage you currently have and there's no net increase in leverage from M&A?

Jason W. Aiken

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

A

I don't want to speak to long-term leverage. We'll get into that depending on the deals that may be out there. I think as it relates to the impact on share repurchase, as I've said, that's always tactical. And while we targeted a 100% return between dividends and share repurchase modified by the acquisition activity, that's a rough number because it's tactical; it's something we shoot for. If it were a penpoint, sort of bullet point at the target, then it wouldn't be tactical; we'd be driving toward a fixed answer. And if you look back over the past couple years, we've in fact well exceeded the 100% return benchmark, and this year we're on target to meet that. So I don't know that it has any direct implication. We'll just have to assess each of those opportunities when they come up and see what they do with respect to the implications on the long-term leverage.

Myles Alexander Walton

*Analyst, Deutsche Bank Securities, Inc.*

Q

Okay, thanks.

Jason W. Aiken

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

A

Sure.

**Operator:** The next question will come from Sam Pearlstein of Wells Fargo. Please go ahead.

Samuel J. Pearlstein

*Analyst, Wells Fargo Securities LLC*

Q

Good morning.

Jason W. Aiken

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

A

Good morning, Sam.

Samuel J. Pearlstein

*Analyst, Wells Fargo Securities LLC*

Q

Just want to talk about the fourth quarter in terms of some of the comments you made. So you said Combat could be up 15% sequentially. That means it's up, call it, 5.5% to 6%. And for the year, that seems like it's a little bit lower than the 7% plan. I just want to make sure I'm doing that correctly. And then second, in IS&T, with this big ramp-up in the fourth quarter, I'm wondering how much of that 20-something percent year-over-year growth that you need to get is coming from this acquisition versus the remainder of the business?

Jason W. Aiken

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

A

Sure. So I'd have to check, and we can go back offline and discuss the math, but the 15-ish percent increase sequentially is entirely consistent with our original forecast of the Combat Systems group being up 7%, maybe a touch higher, approximately 7% full year over 2016. So we're very comfortable with that and that's in the backlog. As it relates to IS&T, as I've said, it is a steep curve in the quarter but we feel very good about it. The pieces are in place to achieve that growth. There are a lot of moving parts but it's in the backlog. We had a good September which leads us to feel like we're very well-positioned to close out the year in a strong fashion. Most of that growth is coming out of the products business, and the order cadence is there to support that. So again, while there's a lot of moving parts, we feel very good about where we are and the pieces are in place to get there.

In terms of the impact of the acquisition, I would say that's not the big driver. It has an impact, but to be honest with you I don't actually have that number in front of me. The big driver is the catch up from the timing we've seen throughout the year and its impact that it's had on our Mission Systems product business. We've talked a good bit about those timing effects of the Army procurement and some of the civil agencies and so on that we've seen delayed by the six-month-plus CR and so on. But we feel good about that timing starting to catch back up this year. If we don't get fully back to the 2016 level, it'll be close and that timing will just spill over a little bit into 2018.

Samuel J. Pearlstein

*Analyst, Wells Fargo Securities LLC*

Q

Okay. Great. Thank you.

Jason W. Aiken

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

A

Sure.

**Operator:** The next question will come from Doug Harned of Bernstein. Please go ahead.

Douglas Stuart Harned

*Analyst, Sanford C. Bernstein & Co. LLC*

Q

Thank you. Good morning.

Jason W. Aiken

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

Good morning, Doug.

A

Douglas Stuart Harned

*Analyst, Sanford C. Bernstein & Co. LLC*

I wanted to stay on IS&T because you're talking about some real progress there, but at the same time we've seen the Army decision to halt WINT-T and you all didn't make it through the down select on JTRS. How are you looking at Army communications now longer-term? Is this an area where – I mean, how should we expect those program situations to affect IS&T longer-term? And is this an area that you perhaps need to shore up or invest in?

Q

Jason W. Aiken

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

Yeah. So look, I think bottom line, when you think about this tactical network backbone for the Army, that is absolutely as square in our core as anything else that's out there, and so we feel very good about the fact that we will continue to be a player from a systems integration role moving forward. Obviously, the Army is yet to define what its revised tactical networking baseline is going to be, so we don't want to get out ahead of that. But as we see it right now, the decisions that have been made to-date and what's on the table at this point has a minimal revenue impact, if any, to 2018. So we feel very comfortable with where we're headed for 2018.

A

And frankly, beyond that, the impact will depend on future Army decisions, so it probably wouldn't be appropriate to speculate and get out ahead of them at this point. What I can tell you, as you are well aware, IS&T is a makeup of a vast portfolio of lots of different opportunities and programs. And so even this one, if it has some impact, is not going to be one that changes our overall long-term outlook for the group. So we feel comfortable that our multi-year CAGR for the group, which I think we gave you at 4.5% or so, remains intact at this point.

Douglas Stuart Harned

*Analyst, Sanford C. Bernstein & Co. LLC*

So that's good; even if you should not get back in on whatever replaces WIN-T, you still feel pretty good about that growth level.

Q

Jason W. Aiken

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

We do feel good. Yes.

A

Douglas Stuart Harned

*Analyst, Sanford C. Bernstein & Co. LLC*

Okay. Okay. Thanks.

Q

**Operator:** The next question will be from Carter Copeland of Melius Research. Please go ahead.

Carter Copeland

*Analyst, Melius Research LLC*

Hey. Good morning, Jason.

Q

Jason W. Aiken

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

Hey. Good morning, Carter. How are you?

A

Carter Copeland

*Analyst, Melius Research LLC*

Good. I wonder if you could expand, since it's not in the release, but with respect to the margin strength, was there anything to note from a gross favorable, EAC adjustments or anything like that? Maybe you could give us some color on how those looked favorable versus unfavorable by segment just to kind of give us some color on what was in there in the margins.

Q

Jason W. Aiken

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

Yeah. I don't have it by segment in front of me. I know the number in aggregate for the quarter was right around \$100 million, which was off a little bit from the second quarter but higher than the first quarter, and that's, of course, right in line with the increased variability we anticipated seeing with these changes under the new revenue recognition model. It did have a good favorable effect on IS&T. I think we had 11.7% margins in the quarter for IS&T. That's not likely to be sustained in the fourth quarter, albeit the margins will continue to be strong for the group in the fourth quarter, but we'll see that come back down a little bit.

A

A little bit of an impact in Combat Systems but not too, too much with respect to changes in estimates or true ups. And in Marine Systems, we did see a couple of modest, albeit a handful of booking rate changes on some of those programs which, in this case, all just happen to line up positively, and so you saw the strong margin in Marine Systems in the quarter. So I would frankly expect to see the Marine Systems margin tick back down a little bit in the fourth quarter but still to show good progress in those yards.

So bottom line, it had an effect. It was favorable to the quarter but not in an outsized way compared to where we've been in the past. And again, barring a similar trend in the fourth quarter, we expect to see some of those margins notch back down just a little bit to a range that we consider to be more normal.

Carter Copeland

*Analyst, Melius Research LLC*

Great. Thanks for the color.

Q

Jason W. Aiken

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

Sure.

A

**Operator:** The next question will come from Robert Stallard of Vertical Research. Please go ahead.

Robert Stallard

*Analyst, Vertical Research Partners LLC*

Thanks very much. Good morning.

Q

Jason W. Aiken

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

Good morning, Rob.

A

Robert Stallard

*Analyst, Vertical Research Partners LLC*

Jason, I thought I would just follow-up on the M&A that you did this year. I know it's relatively small, but does this signal that you're perhaps a little bit more open to do deals going forward? Or does this show that some of the prices have come in relative to what you think is fair, or that some specific assets came up for sale?

Q

Jason W. Aiken

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

Yeah. I really don't think this signals any difference in our perspective or our approach to the market. While we've been fairly quiet on this front for the past few years, it doesn't mean that there hasn't been sort of activity under the surface in terms of looking and evaluating things that are out there. As I've said before, we will continue and will always look at deals that are accretive and are in our core, whether they're large or small. And in this case, a couple of them happen to come in. To speculate about what the future would look like would probably be getting a little bit out ahead of ourselves because I really just don't see what that is. But this will always be our approach until I'm told that it's not. And it's just, again, a focus on accretive core deals and we'll announce them as they come.

A

Robert Stallard

*Analyst, Vertical Research Partners LLC*

And just a follow-up. When you say accretive, are you talking earnings accretive, free cash accretive, and over what period? Is it by year two or something like that?

Q

Jason W. Aiken

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

So specifically, earnings accretive in the first full year. Obviously, if you bring it in late in the year it's going to have a hard time overcoming that geometry. But, yeah, accretive in the first full year and that's earnings accretive and, of course, the cash to follow.

A

Robert Stallard

*Analyst, Vertical Research Partners LLC*

Okay. That's great. Thank you.

Q

**Operator:** The next question will come from Pete Skibitski of Drexel Hamilton. Please go ahead.

Peter John Skibitski

*Analyst, Drexel Hamilton LLC*

Hey. Good morning.

Q

Jason W. Aiken

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

Good morning.

A

Peter John Skibitski

*Analyst, Drexel Hamilton LLC*

Q

Hey, Jason. Can you update us on your expectation for Gulfstream mid and large cabin deliveries for this year?

Jason W. Aiken

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

A

Yeah. No change from what we've talked about earlier. We're still looking to be right at about 120 deliveries for the year. I think if I recall, I don't have it right in front of me, but that's 89 or 90 large cabin and 30 or 31 mid cabin, so that remains unchanged. Obviously, as you get toward the end of the year, you could see a unit flip back or forth, so we'll manage that. But right in line at this point as we look at the balance of the year.

Peter John Skibitski

*Analyst, Drexel Hamilton LLC*

Q

Okay. Just as a follow-up. I was wondering if you're seeing any improvement at all in emerging market demand at Gulfstream.

Jason W. Aiken

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

A

The markets continue to be solid for us. We've sort of hit a familiar drumbeat, right, throughout the past several quarters and even the past couple years. Emerging markets are showing signs of activity. Our core continues to be North America, and that's where over half of our order activity and backlog is centered. But we're seeing, I'd say, probably another quarter of the activity associated with Asia, Asia Pacific. And then if you take other regions notching down, I'd say Europe, then Latin America, then Mideast Africa, sort of in that order in decreasing amounts. But we are seeing decent order uptick activity and customer interest around the globe.

Peter John Skibitski

*Analyst, Drexel Hamilton LLC*

Q

Thank you.

**Operator:** And the next question will come from Sheila Kahyaoglu of Jefferies. Please go ahead.

Sheila Kahyaoglu

*Analyst, Jefferies LLC*

Q

Hey. Good morning, Jason. Thanks for taking my question.

Jason W. Aiken

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

A

Sure. Good morning.

Sheila Kahyaoglu

*Analyst, Jefferies LLC*

Q

Just within Combat Systems, good revenue growth and good EBIT growth. Can you just attribute that to specific international programs, what the ramp should look like? And you mentioned the margin impact. Maybe if you could walk us through what the impact is, any productivity savings off that. Thank you.

Jason W. Aiken

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

A

Sure. So the growth in the group so far this year has really largely been attributable to the ramp in the international programs that we've discussed. We've started the delivery process for those programs. And in fact, we're now up at full rate production for the large Middle East program coming out of Canada. We've started to make initial deliveries on – I think we've made the first handful of deliveries on the UK AJAX program. That will start to build rate and come up to full rate throughout and toward the end of next year, so you'll see some ramp next year attributable to that, and that'll sustain out through the next couple of years and beyond. The Middle East international program, as I've said, is at full rate and will be pretty steady state for the next couple of years. And now we're starting to see the startup of US domestic ground forces recap, and we'll see that more of an influence in the fourth quarter. So I would expect more of the growth that we see in the fourth quarter to be about those programs.

And really, that dovetails into your margin question because we'll start to see those coming in at traditional sort of US Defense entry-level program margins, and so that'll have somewhat of a dilutive effect on the Combat Systems group margins in the fourth quarter as we start up those programs. So a really nice layering of the international programs, the Middle East having a big effect this year, Army recap starting this year and moving into next year, and then the UK program ramping next year and beyond. So I think it's a wholesome position for Combat to be in and supported by the tremendous backlog that they see in that group.

Sheila Kahyaoglu

*Analyst, Jefferies LLC*

Q

Great. Thank you.

Jason W. Aiken

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

A

Denise, we have time for one more question.

**Operator:** Thank you, sir. And that will be for Matt McConnell of RBC Capital Markets. Please go ahead, sir.

Matthew McConnell

*Analyst, RBC Capital Markets LLC*

Q

Thanks. Good morning.

Jason W. Aiken

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

A

Good morning.

Matthew McConnell

*Analyst, RBC Capital Markets LLC*

Q

On the Virginia-class subs, would you have capacity to increase production there to three if there were ever budget support for a higher rate? And then what kind of investment would that require on your part?

Jason W. Aiken

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

A

Well I think your comments taken in reverse order. Number one is if the money is there to support it, absolutely. I would tell you that we have the capacity to move the rate up, so we're at a steady two per year now in the foreseeable future. There is conversation around what to do in years when a Columbia submarine is delivered, and so we'll have to see if there's opportunity from a budget standpoint to add Virginia-class there. But bottom line, we stand ready to do that. We have the capacity to do it and it frankly comes at a relatively minimal investment. The investments at this point moving forward that we're evaluating for Electric Boat really have to do with the Block V module – for the Virginia Payload Module on the next Virginia-class contract – and, of course, the Columbia investments, all of which we're in the process of discussing with the Navy.

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Matthew McConnell

*Analyst, RBC Capital Markets LLC*

Okay. Great. Thank you.

Q

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Jason W. Aiken

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

Sure.

A

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William A. Moss

*Vice President & Controller, 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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**Operator:** And ladies and gentlemen, the conference has concluded. At this time, you may disconnect your lines.

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