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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, ladies and gentlemen, and welcome to the General Dynamics Fourth Quarter and Full Year 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, this event is being recorded.

At this time, I would like to turn the conference over to Mr. Howard Rubel, Vice President of Investor Relations. Sir, please go ahead.

Howard Alan Rubel

Vice President-Investor Relations, General Dynamics Corp.

Thank you, Denise, and good morning to everyone. Welcome to the General Dynamics Fourth Quarter and Full Year 2017 Conference Call. Any forward-looking statements made today represents 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 10K 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. We are very pleased to have Howard join our senior leadership team. Thank you, Howard.

Earlier today, we reported fourth quarter earnings from continuing operations of \$2.10 for fully diluted share on revenue of \$8.28 billion, earnings from continuing operations of \$636 million. This result was impacted by a charge arising from the 2017 Tax Cuts and Jobs Act. The adverse impact was \$119 million and is reflected in an increased tax provision. Adjusting to exclude the impact of this onetime event, we had earnings from continuing operations of \$755 million and adjusted EPS per fully diluted share of \$2.50.

Adjusted earnings from continuing operations were up \$175 million over the year ago quarter. Similarly, adjusted earnings per diluted share from continuing operations were up \$0.61. You can find a more fulsome explanation of this in Exhibits A and B of our press release. I suspect you'll see a lot more of this as other aerospace and defense companies report as you have already seen in other market segments.

Revenue and operating earnings were up significantly against the year ago quarter by 8.1% and 34.6%, respectively. So, all in all, a solid quarter with good performance all around.

For the year, we had fully diluted earnings per share from continuing operations of \$9.56 on revenue of \$30.97 billion and earnings from continuing operations of \$2.9 billion. On an adjusted basis, excluding the impact of tax reform, we had fully diluted earnings per share of \$9.95 and earnings from continuing operations of \$3.03 billion.

Revenue from the year was up over 2016 by \$412 million or 1.3%. Operating earnings were up \$443 million or 11.9% on 130 basis point improvement in operating margins.

Earnings from continuing operations were up \$233 million or 8.7% as reported. Adjusted for the impacts of the Tax Reform Act charge, earnings from continuing operations were up \$352 million, a double-digit increase of 13.1%. All in all, 2017 was a very good year, leaving us well-positioned for 2018.

Perhaps the most important story in the quarter was the cash performance. Free cash flow from operations was \$1.84 billion in the quarter. For the year, we had free cash flow of \$3.45 billion. We advised you at the beginning of the year that free cash flow was going to be approximately 100% of net earnings. In fact, it was significantly better than that. Further, we enjoyed \$1 billion reduction in operating working capital in the quarter as milestone payments were received at Land Systems and cash deposits were received at Gulfstream.

Of note, the cash performance throughout our planning horizon should be very strong. We have a lot to cover this morning, including guidance, so I will review the year and the quarter as adjusted on a year-over-year basis for the groups without reference to the sequential comparison. On a sequential basis, suffice it to say that we had more revenue and lower operating margin. This resulted in operating earnings and earnings from continuing operations that were very similar across all four quarters.

Let me discuss each group and provide some color where appropriate. First, Aerospace. Revenue was up against the year ago quarter by \$1.157 billion or 8.6%, and operating earnings were up \$66 million or 24.1%, the result of a 220 basis point improvement in operating margin. For the full year, revenue of \$8.13 billion was up \$314 million or 4%. Operating earnings of \$1.59 billion were up \$186 million, a strong 13.2% advance on 160-point improvement in operating margins. In sum, an outstanding year at Aerospace with strong operating leverage and very good order intake, particularly in the fourth quarter.

This time last year, we told you to expect revenue between \$8.3 billion to \$8.4 billion with a margin rate between 19.1% to 19.2%. At year end, we had higher margins on somewhat lower revenue driven entirely by negligible pre-owned aircraft sales. By the way, we worked really hard to avoid pre-owned sales because they carry no margin. On the order front, activity in the quarter was very good and pipeline activity was robust. The book-to-bill at Aerospace in the fourth quarter was 1.3 to one dollar denominated and 1.4 to 1 in units.

Let me give you some additional data on this subject as it relates to the quarter and the year. At Gulfstream, net orders were up over 20% year-over-year. Within that increase, mid-sized orders were exactly the same as last year. Net large cabin orders were up almost 30%. Most importantly, on a gross basis, G650 and 650ER orders were up 78% year-over-year.

This is the best G650, 650ER order quarter since 2014 when we had a quarter with a number of multi-aircraft customers. It is also the second best quarter for the G650 and 650ER in order terms since the launch in 2008. So we had a nice increase in large cabin orders led, by the 650 and the 650ER. As we speak, there are over 280 of these aircraft in service with many early customers returning to buy another.

During the quarter, we also announced an increase in the range of the G500 and G600 by 200 and 300 nautical miles respectively at long range cruise of 0.8 Mach. At 0.9 Mach, we increased the G500 range by 600 nautical miles and the G600 by 300 miles. The increased ranges were proven during flight test and can be attributed to very successful control of the weight of these aircraft. And by the way, we announce increases only when we are certain they can be delivered.

We also enjoyed both record sales and earnings for the Gulfstream service business in 2017, which leads me to another subject. I rarely speak to you about the overall market. I usually speak to our own demand, which has held up very well in a slow market. We have clearly gained share from others in this market. Furthermore, my sense is that order activity and customer interest are picking up across the industry. I will look forward to the reports of other OEMs on this subject as they become available.

Next, Combat Systems. At Combat, revenue was \$1.75 billion, up \$87 million or 5.2% and operating earnings were up \$30 million or 13% on a quarter-over-quarter basis on the strength of a 110 basis point improvement in operating margins.

For the full year, sales were up \$419 million or 7.6%. Operating earnings were up \$106 million or 12.8% on an 80 basis point improvement in operating margin, very strong operating leverage here.

By the way, this performance is reasonably consistent with the guidance we provided at this time last year. We actually achieved a better result on somewhat higher revenue, and operating margins were 20 basis points better than guidance.

We continue to see nice order activity in this group with Q4 orders of \$1.7 billion. Tank orders in the quarter were \$975 million, part of the \$2.4 billion IDIQ-type contract that we were awarded in the quarter.

Internationally, demand remained good. We signed a \$1 billion contract for combat wheeled vehicles with Romania earlier this month and the pipeline remains robust, particularly in Europe and the Middle East. In our U.S. market, our U.S. Army customer is modernizing, generating demand across our combat vehicle and munitions businesses, fueling our 0.9 to 1 book-to-bill for the year. This is particularly impressive in a year of nice revenue growth.

In short, this group had quite positive revenue growth and continued its history of strong operating leverage.

For Marine, revenue of \$2.1 billion was up \$163 million or 8.6% compared to the year ago quarter. Operating earnings of \$167 million were up \$125 million against the year ago quarter, which included a charge at Bath Iron Works, which we discussed with you last quarter.

Revenue for the full year was down \$68 million, less than 1%, on lower commercial ship revenue at NASSCO. Growth will resume in our planning horizon. Operating earnings for the year of \$685 million were up \$90 million on a 120 basis point improvement in operating margin. So better margins than 2016, but still not where we need to be.

At this time last year, we told you to expect revenue of \$7.9 billion and operating earnings of \$680 million to \$685 million. So revenue was \$104 million higher than forecast, but operating earnings at \$685 million were consistent with the upper end of the target range.

In response to the significant increased demand from our Navy customer across all three of our shipyards, we are investing in each of our yards. We will spend \$1.7 billion in CapEx at Electric Boat over the next several years in anticipation of increased production on the Block V Virginia submarine and the new Columbia ballistic missile submarine. As you may recall, Block V is a significant upgrade in size and performance, requiring additional manufacturing capacity.

We also have increased our internal training programs as well as our public-private partnerships with Connecticut and Rhode Island to meet our need for skilled trades. Over the last two years alone, we have hired and trained 4,600 highly capable employees. We're also investing over \$200 million in CapEx at Bath and NASSCO to meet the Navy's demand for more destroyers and auxiliary ships. So suffice it to say, we are poised to support our Navy customer as they increase the size of the fleet.

In the Information Systems and Technology Group revenue in the quarter of \$2.49 billion was up \$216 million or 9.5% against the year ago quarter. Operating earnings of \$282 million in the quarter were 22.1% better than the fourth quarter a year ago on 110 basis point improvement in operating margin.

For the year, revenue of \$8.9 billion was down \$253 million or 2.8%, but operating earnings of \$1.01 billion were up \$70 million or 7.4% on the strength of 110 basis point improvement in operating margin, very good operating performance.

Recall that at this time last year, we forecast a modest increase in revenue for the year with operating earnings of \$1 billion to \$1.05 billion and a margin rate of 11%. So the operating earnings came in as guided with lower revenue on a 40 basis-point higher margin rate.

As we have frequently pointed out, IS&T book-to-bill has been at or in excess of 1 to 1 for each of the past four years resulting in a healthy backlog. That said, the transition of that backlog into revenue has been slower than we originally anticipated. The combination of the CR and a new administration slowed the pace of awards, particularly in our Fed/Civ business. While both Defense and Fed/Civ picked up during the second half the year, we simply did not have enough time before year end to recover fully. This leads me to be confident that the growth in this business will materialize beginning in 2018.

On this call, a year ago, on a companywide basis, our guidance for 2017 was to expect revenue of \$31.35 billion to \$31.4 billion and an operating margin of around 13.3%. We wound up the year with revenue of \$31 billion, but we're at the high end of our operating earnings expectations because the operating margin of 13.5% was better than anticipated. Most of the revenue shortfall came in the short-cycle IS&T segment that we just discussed. Last year at this time, we provided EPS guidance of \$9.50 to \$9.55. Without the regard to the \$119 million charge related to tax reform, we wound up at \$9.95, \$0.40 to \$0.45 better.

So let me provide some guidance for 2018 and some out-year commentary on 2019 through 2021, initially by a business group and then a companywide rollout. In Aerospace, we expect 2018 revenue to be \$8.35 billion to \$8.4 billion, up \$220 million to \$270 million. Operating earnings will be slightly in excess of \$1.5 billion with an operating margin rate of 18%. The margin rate is lower in 2017 as a result of mix shift and increased R&D spending as well as a modest increase in pre-owned sales which again carry no margin.

In Aerospace for the five-year period 2017 through 2021, we expect a sales CAGR of slightly more than 7%. That CAGR rolls up a modest sales increase in 2018 with more significant growth in 2019 and beyond. While it is difficult to predict with fidelity our earnings rate, as a result of significant mix shift, we see our earnings growth at a 3.5% to 5% CAGR. We see 2018 as the low point in earnings during the transition to our new model with modest earnings increases in 2019 and 2020 and significant earnings attraction in 2021.

In Combat Systems, we expect revenue to be between \$6.15 billion to \$6.2 billion, a \$200 million to \$250 million increase over 2017, with operating earnings of \$970 million, a \$33 million increase. This implies a margin rate of around 15.7%, very similar to last year. For the period of 2017 to 2021, the expected sales CAGR should be in excess of 6.7% and the earnings CAGR in the low 6% range.

The Marine Group is expected have revenues between \$8.4 billion and \$8.5 billion, a \$400 million to \$500 million increase over 2017. Operating earnings in 2018 are anticipated to be \$7.35 with \$7.45 with an operating margin rate of about 8.7%. The 2017 to 2021 sales CAGR is expected to be 5.6% with very strong growth in 2019 and 2020, and gradually improving operating margins. The expecting earning CAGR for the Marine Group from 2017 to 2021 is about 6.7%.

Finally, in IS&T we expect revenue in 2018 of \$9.3 billion to \$9.4 billion, an increase of \$400 million to \$500 million. We expect operating earnings to be up \$20 million to \$30 million over last year with a margin rate of around 11%. For this group, we see a sales CAGR of 5.5% and earnings CAGR of 5%. So for 2018 companywide, all of this rolls up to \$32.35 billion to \$32.45 billion of revenue, up 4.4% to 4.8% over 2017.

Operating earnings of \$4.25 and an operating margin around 13.1%. This rolls up to an EPS guidance of \$10.90 to \$11 per fully diluted share. Let me emphasize that this plan is purely from operations. It assumes a 19% tax provision and assumes we only buy shares to hold the share count steady with yearend figures so as to avoid dilution from option exercise. So much like last year, beating our EPS guidance must come from outperforming the operating plan, achieving a lower effective tax rate and the effect of capital deployment. With respect to the quarterly progression for EPS, divide our guidance into four and take \$0.35 off Q1, \$0.05 off Qs 2 and 3 and add \$0.45 to Q4.

For the period of 2017 to 2021, we see a consolidated sales CAGR of 6.3% and an operating earnings CAGR of 5%. This is simply a roll up of the projections I've given you for each of the business groups. We are quite bullish about the 2018 through 2021 period in all segments.

Let me turn this call over to Jason for additional commentary and then we'll take your questions.

Jason W. Aiken

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

Thank you, Phebe, and good morning. I'll start with the subject that's getting a lot of attention and impacted both our 2017 results and our outlook going forward. And that's the recently enacted tax reform and our effective tax rate. Our tax rate was 36.9% for the quarter and 28.6% for the full year. Removing the effects of tax reform, our effective tax rate was 25.1% for the quarter and 25.7% for the full year. The unfavorable impact on discussed is due primarily to remeasurement of our net deferred tax asset at the new lower statutory rate as required under generally accepted accounting principles.

Looking ahead to 2018, we expect a full year effective tax rate of approximately 19%. This rate reflects the lower statutory rate on domestic income, the elimination of historic tax benefits such as the domestic production credit and the fact that the tax rates applicable to our international operations are now essentially at parity with our U.S. operations, if not slightly higher. This contrasts with our history where the relatively lower taxes on our international operations had a beneficial impact on our consolidated effective tax rate relative to the previous 35% U.S. statutory rate.

As a reminder, we generally forecast minimal tax benefits from equity-based compensation in our tax rate. This benefit was the primary driver of the steady improvement in our tax rate throughout 2016 and 2017, but we have not reflected a similar level of benefit in 2018 as any impact will be driven by future option exercises, so we'll update our tax rate as they occur.

Our net interest expense in the quarter was \$27 million versus \$23 million in the fourth quarter of 2016. That brings net interest expense for the year to \$103 million versus \$91 million for 2016. The increase in 2017 was due primarily to a \$500 million increase in our outstanding debt in the third quarter of 2016. As you'll recall, we issued \$1 billion of debt in the third quarter of this past year to replace \$900 million of notes maturing in the fourth quarter at a slightly higher interest rate. As a result, we expect 2018 interest expense to increase to approximately \$115 million.

We ended the year with \$3 billion of cash on our balance sheet and a net debt position, debt less cash and equivalents, of \$1 billion. That's down from approximately \$1.6 billion at the end of 2016. As Phebe mentioned, our free cash flow was \$1.8 billion in the fourth quarter and we received significant deposits on new aircraft orders and scheduled progress payments on our large international combat vehicle programs. Cash from operations was \$2 billion in the quarter and \$3.9 billion for the full year.

For 2018, we anticipate cash from operations of approximately \$3.7 billion. On the capital deployment front in the fourth quarter, we purchased 1.9 million shares, bringing us to 7.8 million shares for \$1.5 billion for all of 2017. In total, when combined with the dividends paid, we've returned \$2.5 billion to shareholders in 2017. And we've also made several acquisitions in our Aerospace and IS&T groups this year, totaling \$400 million.

Moving on to our pension plans, we contributed about \$200 million to our plans in 2017 as forecast. For 2018, a minimum contribution is approximately \$300 million to be paid mostly during the second quarter. We'll examine potentially increasing somewhat as the year progresses in light of the opportunity provided by the recent tax reform.

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

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Howard Alan Rubel

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.

Denise, could you please remind participants how to enter the queue?

QUESTION AND ANSWER SECTION

Operator: Certainly, sir. [Operator Instructions] The first questions will come from Robert Stallard of Vertical Research. Please go ahead.

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, a quick question on capital deployment. I was wondering if your plans for future cash deployment have changed as a result of the U.S. tax reform. You obviously ended the year with a very strong balance sheet and cash flow.

Q

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

Well, let me just reiterate what our tax – what our cash deployment, capital deployment strategy has been. First, we invest in our business where we believe that we can get a good return. We're in a period right now of growth that needs to be supported by investments. And happily and propitiously, we have a tax bill that gives us more free cash flow. So it's a nice marrying of objective and reality. We also look for transactions, acquisitions that are accretive and in our core. And you saw some of that this past year in 2017.

A

The only – and we've talked about this for many years, the only long-term, steady, reliable, repeatable element of cash and capital deployment are dividends. Share repurchases, we covered dilution, and then all of our other share repurchases have been tactical. So I don't see a particular change in the strategy. The tactics, of course, are driven by the needs of the business, and in the case of tax reform, provide us additional free cash flow. So a happy event.

Robert Stallard

Analyst, Vertical Research Partners LLC

Okay. Thank you.

Q

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

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

Q

Good morning.

Phebe N. Novakovic
Chairman & Chief Executive Officer, General Dynamics Corp.

A

Good morning.

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

Q

Wanted to go back to your Aero margin guidance for 2018 and the small contraction there on the mix shift and the higher R&D, and the slightly higher pre-owned I guess. Phebe, with the timing on the 500 and 600 wrapping up, would've thought R&D might have tracked down a little bit, maybe there's something else you're developing there. And how is pricing on the aircraft that will deliver in 2018 versus 2017?

Phebe N. Novakovic
Chairman & Chief Executive Officer, General Dynamics Corp.

A

Well, first of all, we never discuss price. But suffice it to say, that is not driving any margin changes or compression. So I think it might be appropriate just to remind ourselves where we've been for the last couple years and where the next two years, this year and 2019 are. So we've been in a transition period, and think about the transition in two pieces. One, that we've been living through for the last two years where we're bringing down 450, 550 production. And to offset any earnings decline as a result of that, we committed to attempt to keep earnings flat by increasing somewhat the 650 production, which we have done, in addition to cutting costs and improved operating efficiency and good planning. All of that has happened.

Now as we move into the full throttle transition where the 450 is out of production this year, the 550 is coming down to a low rate, an ultimately very low rate production, we're feathering back some 650s as it's appropriate and as we told you we would, and the advent of the 600 comes on board, 500 and then 600. So we're pretty much on track, we're very much on track [ph] in exactly (28:37) the progression, the magnitude and the duration of this transition period that we have been in. We never discuss our R&D, but again, suffice it to say that it has been robust and it will continue to be robust going forward.

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

Q

So, Phebe, if I might, is it – are you saying it's just a bit of learning curve on the new platforms?

Phebe N. Novakovic
Chairman & Chief Executive Officer, General Dynamics Corp.

A

Sure. So let's talk about new platforms, always have a – they start out at a lower margin rate and improve over time as we come down our learning curve. In addition, the first lot of any new airplanes, tend to carry with them lower margins. So, as we get the first lot of the 500 and 600 out of the production line and we improve our learning, which we have done historically and I'm confident we'll do again, then we will eventually see margin expansion. And that's the kind of earnings growth I'm talking about in the latter end of our planning period.

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

Q

Thank you very much.

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

Samuel J. Pearlstein
Analyst, Wells Fargo Securities LLC

Q

Good morning.

Phebe N. Novakovic
Chairman & Chief Executive Officer, General Dynamics Corp.

A

Good morning.

Samuel J. Pearlstein
Analyst, Wells Fargo Securities LLC

Q

Can you talk a little bit about how we should think about the net income conversion to free cash flow in 2018, just given the tax change, the additional pension contribution, and then just the capital spending plan? And just overall, does this CapEx continue to grow from this level into even next year? Just how do we think about that?

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

A

Sure. So we gave you some figures on operating cash flow in the remarks around, call it, \$3.7 billion. And I think to your point, with the tax reform and as Phebe alluded to, that increases net income, and by like amount, increases free cash flow. So I don't think tax reform necessarily had – in fact, I know tax reform didn't have an impact on our free cash conversion rate. What it does provide us is additional free cash flow that we can then deploy.

And as Phebe mentioned, we have opportunities, including in our shipyards as well as additional R&D and product development opportunities across the business, to invest in the growth of the company, and that is something we intend to continue to do.

So between those opportunities that will notch up or down over the course of the year and beyond as well as I alluded to, the opportunity to perhaps take advantage of the tax reform to fund a little bit more into our pension plans, the free cash flow conversion could end up approaching 100%, if not 100%. We continue to target that range, but call it still in the 90s. We well exceeded 100% in 2017 even beyond our original expectations, but we're back structurally in that range. And so I think that's how you need to think of it. But we'll probably focus more on operating cash flow as a number that's more directly targetable because some of those other levers will move up and down. CapEx, R&D, and so on, to support the growth of the business, and they could move the cash conversion rate from the mid-90s to the 100% range depending on where those ultimately end up, all opportunities for growth in the business.

Samuel J. Pearlstein
Analyst, Wells Fargo Securities LLC

Q

But you – I mean, you mentioned the \$1.7 billion being spent to the EB, and just what is the absolute level of CapEx we should expect in 2018?

Jason W. Aiken

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

A

So we typically target around 2% of sales. We've come in a little lower than that in the past, so I'd expect to see us toward the higher end of that this year. And in terms, I think you asked a question about how does that plan over time, some of that is still in play. It's a longer-term plan, but I think you'll see it come up a little bit over the next few years and then ebb back down as we go through that facility master plan.

Samuel J. Pearlstein

Analyst, Wells Fargo Securities LLC

Q

Okay. Thank you.

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

Douglas Stuart Harned

Analyst, Sanford C. Bernstein & Co. LLC

Q

Good morning.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

Good morning.

Douglas Stuart Harned

Analyst, Sanford C. Bernstein & Co. LLC

Q

Phebe, when you talked about the guidance for this year and also the five-year guidance, how are you thinking about the budget situation, in other words, the continuing resolution? We're in the fourth one now. It's not completely clear where this is going to go. Where do you see, you mentioned IS&T before, but where do you see the biggest issues in your portfolio if we have a further extension of CRs? And how have you dealt with this in your guidance short- and long-term?

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

So the budgets have been very supportive of our program of records and our new programs, and I haven't seen any surprises there. Typically, we can cover a relatively short-term CR rather wholesomely, and this year was a little bit different, and I can get into that if you wish. But what we've done is appropriately hedge our guidance with some expectations around varying lengths of the CR. So we'll be in, I believe, better shape and we're comfortable that we're in better shape this year with an extended CR than we were last year.

Just to give you little bit of color, what happened last year, in particular with IS&T, which let's talk about, the short cycle businesses tend to be more affected by a CR, but typically we can cover that. In 2017, we had a couple of other things happen, and let me restate that or reinforce that the vast preponderance of the 2017 revenues that we didn't get in 2017 and moved into 2018, but in addition to the CR, we had a number of new army startups which had a disproportionate effect on the impact in both GDIT and Mission Systems. You may also recall that the Army stopped funding WIN-T and some other related comms programs until they completed their network and battlefield review, so that drove a couple of months of revenue from 2017 to 2018. And then we had a new administration with some unanticipated civil agency cuts that we had not forecasted. But that's been addressed by

our customers and Fed/Civ as they have modified their plans. So I think our ability to manage a CR is significantly better this year because I don't see any of those other factors contributing to perturbation in the IS&T sales.

Douglas Stuart Harned

Analyst, Sanford C. Bernstein & Co. LLC

And presumably, also in your outlook, you've got, like Combat, for example, you've got a lot of international in there as well. I'm assuming that's a big, that's an important part of that growth rate.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

It is, but don't underestimate the increase in modernization funding coming from the army. That becomes an increasingly large component of our backlog throughout our planning period.

Douglas Stuart Harned

Analyst, Sanford C. Bernstein & Co. LLC

Okay. Great. Thank you.

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

Peter John Skibitski

Analyst, Drexel Hamilton LLC

First, good morning, Phebe, Jason and Howard. Phebe, we've had the new National Defense Strategy released last week and there's a lot of strategy shift, I think, more so to peer conflict in various areas of modernization needed. How do you think GD's capabilities match up with that new strategy given at some point I think the money will follow the strategy?

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

Well, I think very well. I have long said that I like the positioning of our platform, defense platform businesses because they tend to be somewhat countercyclical. In a hot war, the tactical forces receive the preponderance of the funding, and that was true certainly in the hot wars of Iraq and Afghanistan. When we wind down from active, intense conflict, then the strategic forces, which in our case is the Navy, tend to receive more funding.

In this instance, what we have is a little bit of a combination of both. We need to grow the fleet for the obvious threats that we have in the North Atlantic and Pacific. And the army needs to recapitalize based on – it's had a number of years, over a decade, of consumption of its material, but it needs to not only replace but upgrade that material when they put the money behind it. So I think we're well balanced. I don't want any particular surprises in any of the studies that have come out recently, and we had factored all of that into our thinking [indiscernible] (37:43).

Peter John Skibitski

Analyst, Drexel Hamilton LLC

Just to go further on ground vehicles, Congress added an awful lot of money in its markup for fiscal 2018, is there maybe even some room for upside to your Combat forecast if that money comes through?

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

Well, let's put it this way. We are mindful that there can be an appetite for increasing particular programs, and ours have been very heavily supported, particularly in the authorization process. But the appropriations have to follow. We're very comfortable that the programs that we have, our core programs of record and appropriations bill are fully funded. And frankly, this is true across our portfolio, the more money that's available, the higher our revenue and opportunities can be. So I'm comfortable with where we are in the moment on our projections given what we believe to be the likely outcome of at least the near-term budget cycle.

Peter John Skibitski

Analyst, Drexel Hamilton LLC

Q

Fair enough. Thank you.

Operator: The next question will be from Ron Epstein of Bank of America. Please go ahead.

Ronald J. Epstein

Analyst, Bank of America Merrill Lynch

Q

Good morning, guys. Phebe, you gave us some pretty good detail already on the sales backdrop for Gulfstream. Can you give us some more color on kind of who's buying these jets? Is it Fortune 500s? Is it across the board? Is it the U.S.? Is it Europe? Is it Asia? And then a follow-on to that would be, what's your sense now on the JSTARS program, because that could have an impact for 550 production.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

So our order activity, and frankly, our backlog are heavily United States, Canada and Europe, Far East, lesser extent Mideast. And let me tell you something about our backlog, the way you need to think about it. We understand every single buyer in our backlog. We know them. They're sound financially. It's a sticky backlog and we have very few fleet customers. So, as between – so it's a very steady, sturdy backlog. And the mix between public companies, private companies and individuals vary, usually about a third, a third, a third. And in any given quarter, that can go up a little bit among those three categories. But no material difference in the last few years in what we're seeing in terms of the consist and geographical location of our customer base.

JSTARS, I refer you to Northrop because they're our prime, but the 550 will be in low to very low rate production for the foreseeable future, and we'll support the plan that Northrop has for us.

Ronald J. Epstein

Analyst, Bank of America Merrill Lynch

Q

Okay. Great. Thank you very much.

Operator: The next question will be from Jon Raviv of Citi. Please go ahead.

Jon Raviv

Analyst, Citigroup Global Markets, Inc.

Q

Hey, good morning, everyone.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

Good morning.

A

Jon Raviv

Analyst, Citigroup Global Markets, Inc.

Just a slight follow-up on that capital allocation question. Just can you talk, Phebe and Jason, a little bit more about the M&A outlook? You brought up some of the acquisition activity you had in 2017. Any kind of shift in the market that you're detecting heading into 2018, and where you might be interested, and to what extent, from a bite-size perspective?

Q

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

We never comment on the environment for acquisitions, so I think I'll pass on that. Do you have another question?

A

Jon Raviv

Analyst, Citigroup Global Markets, Inc.

Sure. I appreciate that. When it comes to the CapEx plans at your shipyards, how do you think about the returns on that CapEx? I mean, is that associated with plans that you know are in place that the Navy is going to be able to afford? Or is there a little bit of assumption or intention that improving the shipyards will help the Navy afford their larger shipbuilding plan?

Q

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

Look, we have always been very disciplined about our capital deployment, and you can expect in this instance that we have planned our investments as close in time to the returns as possible. The Navy understands that. There are contractual provisions in all of our contracts that provide for a harmonizing across to better optimize the investment with the return. We're not speculative. The nation needs to fund the submarine force in particular. And our investments are twofold. One, they clearly make us more efficient, but it also helps the affordability for the Navy. So it's a win-win for both us and the Navy, and we're in very close contact and have been completely aligned with the Navy with respect to the quantum and the timing of our investments. And they fully understand the need for a reasonable return.

A

Jon Raviv

Analyst, Citigroup Global Markets, Inc.

Got it. Thanks for the second swing at the ball there.

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, Phebe, Jason, Howard.

Q

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

Good morning.

Carter Copeland

Analyst, Melius Research LLC

Q

Phebe, just a quick clarification on a comment you made earlier and then just a question on demand. But the initial production lot on new programs comment that you made before, if you could just clarify what is the size of a typical initial early production lot for a new airplane.

And then just with respect to the demand outlook, and I know you kind of hinted at this with the industry-wide comment on expanding orders or – let me get the words wrong here, across the industry. But when you look at the plan that you laid out through 2021, I'm just trying to get a sense of what the underpinnings are there and if there's any expectation that tax reform has a material impact on buying decisions. I realize we're only a couple of weeks into the year, but any chance you can help us understand how to quantify what those sorts of impacts might be or what you expect or where you may have been conservative? Anything there would be helpful. Thanks.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

Well, let me just say one thing here about tax reform. It can't hurt, right?

Carter Copeland

Analyst, Melius Research LLC

Q

Absolutely.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

So it will help. We'll see how that plays out, but it frankly didn't factor into our projections. The demand, we based our plan on the demand that we see – both what I've called now for many, many quarters, the robust pipeline. The pipeline remains robust and we are a big believer because history actually supports this view, and experience supports this view, that new product generates additional incremental demand. We've got new product coming out. So I'm comfortable that our demand projections, it's going to manifest in our deliveries, are reasonable. And let me – so I think that – I hope that gives you a little bit of color but let me ask Jason to address the lot.

Jason W. Aiken

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

A

Sure. And yeah, and without getting into the specifics of our inventory numbering system, suffice it to say, a lot of aircraft at Gulfstream we would burn through within a year in terms of delivery. So, when you think about the 500 or any airplane that's entering into service, there's going to be a natural production ramp. And so we won't quite get through the first full lot in this year but there will be a handful of units that'll deliver in the early part of next year. So we'll be through that first production lot by early next year.

Carter Copeland

Analyst, Melius Research LLC

Q

So we're talking not a handful but a dozen or dozen something like that?

Jason W. Aiken

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

Exactly. It's more than a handful.

A

Carter Copeland

Analyst, Melius Research LLC

Great. Thanks for the color.

Q

Howard Alan Rubel

Vice President-Investor Relations, General Dynamics Corp.

And thank you, Carter. And we have time for one more question.

A

Operator: Thank you. And that will be from Hunter Keay of Wolfe Research. Please go ahead.

Hunter K. Keay

Analyst, Wolfe Research LLC

Hey, thanks for squeezing me in. I appreciate it. If you could, to the extent possible, Phebe, talk about talk about any incremental interest you maybe saw with the effect of push out of Falcon 5X. And maybe a broader question around that, so it's two-part question, how often do you see BizJet customers and general switching brands? Does most competition come from competitors or is it really yourselves as always kind of competing against each other with new product offerings? How often do you see switching broadly speaking?

Q

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

Well, historically, and this is historically, customers have been pretty loyal to their particular brand. I think over the last three, four, five years, we've seen some – we've seen changes in that prior behavior and we have gained share. We now have customers in our backlog and are delivering airplanes to customers that were in other peoples – other airplane manufacturers, historical customer set.

A

So I don't really think about it, and I don't really know, how much is from any particular, how much of our incremental increases in our order books and in our backlogs has been the result of others. But frankly, we're the only ones really out there in the moment with a lot of new airplanes. We've got the 650, we've got the 500 and 600 coming right in behind it, and then frankly, the 280. So that, I believe, is the single largest reason for the increase in our backlog and more importantly in our orders and deliveries in the moment. So...

Hunter K. Keay

Analyst, Wolfe Research LLC

So would you say loyalty is more a function of sort of capabilities? Or do you sometimes see that opportunity to take share if there's, say, manufacturing or production delays at some your competitors? Thanks so much.

Q

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

Well, I'm really not going to talk about our strategy. I don't worry too much about what the others are doing. I think we just have to focus on doing what we do well and what we do well is we are the low cost, high quality producer across all of our fleet of airplanes. And we have also funded and are executing a robust R&D program that has

A

allowed us to bring in consistently new product. I'll focus on that. I believe that is what ultimately drives success, and that is what you're seeing in the Gulfstream performance.

Howard Alan Rubel

Vice President-Investor Relations, General Dynamics Corp.

Thank you for joining our call today. If you have additional questions, I can be reached at 703-876-3117. Again, thanks for your time. You may disconnect.

Operator: Thank you, sir. Ladies and gentlemen, the conference has now concluded. Thank you for attending today's presentation. At this time, we will ask you to disconnect your line.

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