

25-Jul-2018

General Dynamics Corp. (GD)

Q2 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to the General Dynamics Second Quarter 2018 Earnings Conference Call. All participants will be in listen-only mode. [Operator Instructions] Please note today's event is being recorded.

I would now like to turn the conference over to Howard Rubel, Vice President, Investor Relations. Please go ahead sir.

Howard Alan Rubel

Vice President-Investor Relations, General Dynamics Corp.

Thank you, Rocco, and good morning, everyone. Welcome to the General Dynamics second quarter 2018 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 Chairman and Chief Executive Officer, Phebe Novakovic

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

Good morning. As you can discern from our more expansive press release, we enjoyed a very good second quarter with revenue of \$9.19 billion and net earnings of \$786 million. We reported EPS of \$2.62 per diluted share \$0.17 a share better than the year ago quarter and \$0.12 per share better than consensus. Compared to the year ago quarter revenue of \$9.19 billion was up \$1.51 billion or 19.7%. Of this number, approximately 3% represents organic revenue growth with the remainder coming from the acquisition of CSRA.

Net earnings of \$786 million were up \$37 million or 4.9% on the strength of a \$21 million improvement in operating earnings and a lower effective tax rate offset in part by higher interest expense. This was particularly impressive given the \$70 million of one-time costs in the quarter related to the acquisition of CSRA but a little more on that from Jason in a minute.

Sequentially, the story is much the same. Revenue was up \$1.65 billion or 21.9% and operating earnings were up \$80 million or 7.9% on the lower operating margins attributable to the \$45 million of the \$70 million one-time costs associated with the acquisition of CSRA reported as corporate operating earnings. The other \$25 million was reported in other expense.

Let me turn briefly to the first half of 2018 compared to the first half of 2017. Revenue was up \$1.61 billion or 10.6% against the first half of 2017 for the same reasons, both the acquisition of CSRA and organic growth. On the other hand, operating earnings were down \$17 million burdened by the aforementioned \$45 million of cost in connection with the CSRA acquisition and increased amortization. Earnings from continuing operations were up \$73 million, a 4.8% increase. EPS was \$0.33 better, a 6.7% increase.

In short, we had a very good second quarter and first half. We are somewhat ahead of both our internal plan and external expectations. The CSRA acquisition performed as expected. Impressively, the acquisition would have been accretive in the quarter absent the onetime period of costs associated with it. These onetime period of costs burdened EPS by \$0.20 per share in the quarter. The acquisition will be accretive to EPS in the second half mostly in the fourth quarter. And again, Jason will give you a little bit more color on this in a moment.

Let me give you some perspective on the segment reporting for the quarter and for the half and then I'll ask Jason for some comments on the CSRA acquisition cash, backlog, and taxes, before I conclude with some comments on the outlook for the business and each segment for the remainder of the year.

First, Aerospace. Aerospace had a very good quarter in all important respects. Revenue of \$1.9 billion and operating earnings of \$386 million were \$183 million and \$35 million lower respectively, but consistent with our outlook and the production plan for the year. Operating margin improved 10 basis points to an impressive 20.4%. On a sequential basis, revenue was up \$70 million and operating earnings were up \$40 million on a 140 basis point improvement in operating margin.

We enjoyed brisk order activity in the quarter. The dollar-based book-to-bill was a strong 1.3 to 1. This brings the book-to-bill to 1 to 1 for the first half and for the last 12 calendar months as well. One year ago at the end of the second quarter, the Aerospace funded backlog was \$12.12 billion. At the end of this quarter, it was \$12.19 billion.

Total backlog is up from \$12.24 billion to \$12.34 billion. Total estimated contract value is up \$14.15 billion to \$14.63 billion. So as you can see, we have had very good order performance for a full year now. The 650 and 650ER led the way in the quarter. The interest in all of our products remains quite good. The demand signals in North America are very good and growing in Europe as well.

We are comfortable with the anticipated third quarter orders based on early orders, contract discussions and our pipeline. In short, we expect a good third quarter and second half from an order perspective. Book-to-bill should be 1 to 1 or better in the second half better than that in the third quarter and lower in the fourth quarter because of higher anticipated deliveries. However, we could do a bit better in the fourth quarter.

As you know, the G500 was certified on July 20. This now paves the way for pilot training in the third quarter and deliveries commencing early fourth quarter with a few possibly in Q3. G600 flying continues to go well. We look forward to certification in the fourth quarter of this year.

In May, we also closed the acquisition of Hawker Pacific. It adds to Jet's global footprint, demonstrating a willingness to invest in support of our customers in locations convenient to them. This business will be part of a Jet Aviation-Gulfstream strategy to support a joint service effort outside of the United States.

Let me now turn to the defense side of the house. At the outset, let me say that the collective revenue of the defense businesses was up 7.1% over the year ago quarter excluding the impact of CSRA.

Turning to the individual segments, Combat Systems had a very good quarter as the relevant comparisons clearly indicate. Revenue of \$1.53 billion was \$120 million more than the second quarter last year, up 8.5%. Similarly, operating earnings were \$236 million, up \$11 million, or 5% over the second quarter of 2017. I should remind everybody that the second quarter of 2017 represented a 9% improvement over second quarter 2016 in revenue and almost 10% in operating earnings. So we have experienced strong quarter-over-quarter growth for two years now.

On a sequential basis, the story is similar. Revenue was up \$94 million or 6.5% and operating earnings were up \$12 million or 5.4%. For the first half, revenue was up \$273 million, slightly in excess of 10% against the first half of 2017. Operating earnings were up \$30 million or 7%. Our U.S.-based programs continue to perform well with Abrams volumes up and nice growth in the ordnance and munitions portfolio.

The Army continues to exploit the versatility of the Stryker with a \$260 million contract in the quarter to upgrade the electronics, power and communications on the vehicle. This contract is part of the Army's plan to similarly upgrade all of their nine Stryker Brigades.

We also received a \$440 million order to upgrade Abrams tanks to the Version 3.0 configuration, which provides improved power, survivability and lethality. The continued monetization of our platforms in the coming years is, for the first time in a while, manifest in explicit program direction for the tank and the Stryker which puts us in good stead for continued growth.

Our international programs continue to see nice growth as well. Work on the UK AJAX program is transitioning to production from engineering with peak production in 2021. We are obviously trending in the right direction at combat. It is a very nice growth story.

With respect to the Marine segment, revenue of \$2.17 billion was \$89 million higher than Q2 a year ago. Operating earnings were up \$17 million against the year ago quarter on a 40 basis point expansion in operating profit. Similar to Combat Systems, the 2017 quarter experienced nice growth in both revenue and earnings against the same quarter in 2016. So once again, two years of good growth.

On a sequential basis, revenue was up \$134 million and operating earnings were up \$11 million at 6.6% and 6% respectively. For the first half, revenue of \$4.2 billion was up \$189 million or 4.7% against the first half of 2017. Operating earnings were also up by \$40 million or 11.8% on a 60 basis point improvement in margin to 9%.

Work on our submarine programs, the Virginia class construction and engineering on the Columbia ballistic missile submarine, continues to make good progress. We are building Virginia-class Block IV boats and have begun to purchase long lead material for the Block V. We expect the Block V contract to be awarded later this year.

With respect to Bath, the challenges on the first DDG-1000 boat and the DDG-51 restart ships are largely behind us with nice performance from the DDG-1001 and 1002 and on the follow on DDG-51 ships. We expect a multi-year contract to be awarded later this year for the DDG-51 Flight III upgrade.

Finally, surface repair at NASSCO had a slower start than anticipated this year but will ramp up in the second half. In all, Marine Systems has been a compelling growth story for us and will continue to be so for a long time to come.

We are now reporting what was IS&T in two segments: first, Mission Systems, a large C4ISR business; and second, Information Technology, one of the industry's largest providers of IT services to the Department of Defense, intelligence agencies, and federal civilian agencies.

Let's start with Mission Systems. Mission Systems had revenue of \$1.15 billion in the quarter, an increase of \$95 million or 9% over the year ago quarter. Earnings of \$153 million were steady against the second quarter last year as a result of a 120 basis point drop in operating margin due to program mix in the quarter. We expect that mix to improve in the second half.

Mission Systems reports internally in three lines of business: ISR systems, communications, and platforms and sensors. Growth year-to-date for Mission Systems was primarily in ISR, in particular space payloads and encryption, and in communications.

On a sequential basis, revenue was up \$49 million and earnings were up \$7 million. On a year-to-date basis, Mission Systems revenue was up \$105 million or 4.9%. Once again, first half earnings were steady against the first half of last year. Mission Systems has been a good growth business for us and will continue to be so. It has enjoyed a book-to-bill of 1 to 1 in 2016, 2017 and the first half of 2018.

Information Technology reported revenue of \$2.44 billion in the second quarter. CSRA's contribution in the quarter was \$1.29 billion. The revenue of Legacy GDIT was up \$96 million or 9.1% excluding CSRA against the year ago quarter.

Operating earnings were \$156 million with a \$72 million contribution from CSRA, which includes \$62 million of an amortization charge as a result of the transaction. Margin was 6.4% versus 8.3% the year ago quarter as a result of CSRA intangible asset amortization.

On a year-to-date basis, revenue was \$3.58 billion, was up \$1.4 billion. Importantly, revenue in the first half was up \$176 million or 8.3% excluding the impact of CSRA. On a year-to-date basis, earnings were up \$80 million or 45.2%. Operating margins of 7.2% compares with the first half of last year of 8.4% consistent with the second quarter results.

Our integration of CSRA into GDIT is going well and is ahead of our internal schedule. Our management team pulled from both businesses has gelled nicely. We are meeting cost synergy targets and are working to exceed this year's goal.

The strength of GDIT post acquisition is in the experience of both GDIT and CSRA in developing cost effective solutions for its customers and leveraging this experience across multiple agencies. Both companies are excellent at transitioning old IT solutions to secure cloud-based solutions that are easier to operate and maintain. Together, we are even better. We expect this to be a competitive and powerful combination of talent and know how.

So, in summary, in the quarter, General Dynamics accomplished a number of key strategic objectives and delivered solid operating results. We closed on the largest acquisition in GD's history, expanded Jet Aviation's service network in Australia and the Asia Pacific region, and grew earnings and backlog.

I'll now turn the call over to Jason and then come back to you with our outlook for the rest of the year.

Jason Wright Aiken

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

Thank you, Phebe, and good morning. I'll start with the income statement and, in particular, the areas that are impacted by the CSRA acquisition. First, as Phebe noted, are the onetime transition costs we incurred associated with the acquisition. A portion of these costs, largely related to change of control provisions, are reported in our operating earnings as required by Generally Accepted Accounting Principles, while the balance, legal, accounting, and other advisory fees, is reported in other income and expense.

In the quarter, we recognized \$45 million of transaction costs in corporate operating earnings and \$25 million in other expenses below the line for a total of \$70 million in the quarter. You'll recall, we recognized \$5 million of

these one-time fees and other expenses in the first quarter and we anticipate the final payments in the third quarter to bring us to a total transaction cost of \$80 million or \$0.23 per share. Including these onetime charges, we expect corporate operating costs and the other below the line expenses to each be approximately \$25 million for the year.

Turning to net interest expense, we reported \$103 million in the quarter, compared to \$24 million in the second quarter of 2017. That brings the interest expense for the first half of the year to \$130 million versus \$49 million for the same period in 2017. The increase in 2018 is due to the roughly \$10 billion of debt we issued to finance the acquisition of CSRA. For the year, we now expect net interest expense to be approximately \$355 million versus our initial pre-acquisition January guidance of \$115 million.

Wrapping up the discussion of CSRA, the second quarter numbers include provisional amounts related to purchase accounting for CSRA. Although, not final, we believe we have good estimates of the acquired intangible assets and the related amortization expense. These estimates are very much in line with what we reported in our recent 8-K filing associated with this transaction, which are approximately \$2 billion of intangible assets and a \$190 million of amortization for the nine months of 2018.

Moving on from CSRA, our effective tax rate was 19% for the quarter which is consistent with our full year outlook. You'll recall, our first quarter tax rate was somewhat lower due to the timing of benefits associated with equity compensation deductions so the rate for the first half of the year was 17.9%. That quite naturally implies a rate higher than 19% for the balance of the year to net a full year rate of 19%.

Turning to capital deployment, we paid \$276 million in dividend in the second quarter. We also purchased 900,000 shares of our stock, bringing us to 2.1 million shares for the first half of the year for \$436 million. This is consistent with our plan to acquire enough shares in 2018 to hold our share count steady. Our focus for the balance of the year will be on paying down the incremental debt from the CSRA acquisition, consistent with the near-term maturity structure that we established.

We generated \$787 million of cash from operations in the quarter and, after capital expenditures of \$175 million, we have free cash flow of \$612 million, a conversion rate of nearly 80%. That resulted in a net cash balance of \$1.9 billion at the end of the quarter and a net debt position of \$12.4 billion.

For the year we expect free our cash flow to be in the low to mid 90% range reflecting our typical 100% conversion target, less the additional \$255 million discretionary pension contribution that we discussed last quarter, which we paid in the third quarter.

Lastly, a couple of highlights on our backlog. First, the addition of CSRA brought \$5.3 billion of firm backlog to the company along with \$8.5 billion of IDIQ and unexercised options, what we refer to as estimated potential contract value. In addition to this incremental backlog, the combined GDIT-CSRA had a book-to-bill ratio of 1.2 times in the quarter bringing them to 1.1 times for the first half of the year.

And one last point regarding the impact of foreign exchange rate fluctuations as it relates to backlog. While FX rates had a de minimis impact on our reported sales and earnings in the quarter, changes in the rates from the end of the first quarter to the end of the second quarter reduced our Combat Systems and Mission Systems backlogs by approximately \$370 million and \$75 million respectively. Excluding this impact, these two groups had a book-to-bill in the quarter of 0.9 times and 1 to 1 respectively.

In fact, our defense businesses in aggregate had a book-to-bill of 0.9 times in the quarter and first six months of the year and that includes a very lumpy Marine Systems where, as Phebe noted, we anticipate some very large additions to the backlog in the form of a multi-year DDG and Virginia Block V contract later this year. Combined with the strong order activity and ongoing environment that Phebe described in the Aerospace group, we're set up to continue what's developing as a very nice growth story.

That concludes my remarks, and I'll turn it back over to Phebe to give you a wrap up including our updated guidance for the year.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

So let me provide our forecast for the year for each segment and compare it to what we told you in January and then wrap it into our EPS guidance. For Aerospace, our guidance was to expect revenue of \$8.35 billion to \$8.4 billion up \$220 million to \$270 million from 2017, operating earnings slightly in excess of \$1.5 billion and operating margin of around 18%.

We now expect revenue of approximately \$8.6 billion, with earnings roughly consistent with our January forecast. This implies pressure on margins in the second half particularly in the fourth quarter when G500 deliveries begin in earnest.

For Combat Systems, our previous guidance was to expect revenue of \$6.15 billion to \$6.2 billion, up \$200 million to \$250 million from 2017 with operating earnings around \$970 million on an operating margin of around 15.7%. We now expect revenue of \$6.3 billion to \$6.35 billion, operating earnings of approximately \$990 million, with an operating margin around 15.5%, so approximately \$150 million more revenue and \$20 million more in operating earnings.

For the Marine segment, we previously guided to revenue of \$8.4 billion to \$8.5 billion, margins are at \$8.7 billion and operating earnings of \$735 million to \$745 million. We now expect revenue to be slightly over \$8.5 billion with margins slightly better than the previous forecast resulting in operating earnings of \$745 million to \$755 million.

For IS&T, we guided to revenue of \$9.3 billion to \$9.4 billion, up \$400 million to \$500 million from 2017, operating earnings of \$1.03 billion to \$1.04 billion, with a margin rate of around 11%. It now appears that our revenue forecast for the two legacy businesses is between \$9.4 million and \$9.5 billion. Rather than taking it any further of the old IS&T level, let me break it into the new business segments.

First, Mission Systems. Their outlook for this year is revenue between \$4.8 billion to \$4.9 billion with margins around 14%. This implies significant growth in revenue and earnings in the second half. Second, legacy GDIT will have revenue for the year of about \$4.6 billion with margins around 8%. CSRA will add about \$3.75 billion of revenue with operating margins growing 6%.

So IT rolls up revenue of between \$8.3 billion and \$8.4 billion with operating earnings around \$600 million and margins around 7%. So all of this sums to revenue for GD about \$36.7 billion to \$36.8 billion and operating margins somewhat in excess of 12%.

Compared to our initial guidance, we will have higher revenue and operating earnings. This permits us to increase our EPS outlook from a range of \$10.90 to \$11 to a range of \$11 to \$11.05. This increased outlook overcomes what we expect to be a \$0.23 per share negative impact from all the charges related to the CSRA acquisition.

Apart from those fees and expenses, we expect CSRA's contribution to be \$0.11 this year. The difference then is from GD operating improvement.

With that, I'll turn it back to Howard and address your questions.

Howard Alan Rubel

Vice President-Investor Relations, General Dynamics Corp.

Thanks, Phebe. 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. Rocco, could you please remind participants how to enter the queue?

QUESTION AND ANSWER SECTION

Operator: Absolutely, Sir. [Operator Instructions] Today's first question comes from Ronald Epstein of Bank of America. Please go ahead.

Ronald J. Epstein

Analyst, Bank of America Merrill Lynch

Hey. Good morning, everyone.

Q

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

Hi, Ron.

A

Ronald J. Epstein

Analyst, Bank of America Merrill Lynch

I think one topic that's sort of in the back of everybody's mind, if you could maybe put some perspective on it is one of the suppliers on the G500 is having financial difficulty, filed for bankruptcy and they're a supplier to you, your supplier Pratt Canada, so the Northern Group. I mean, how should investors think about what potential impact that could have and what it means? Because we're just getting a lot of questions on it and I think people just want to get a sense on how you're thinking about that.

Q

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

So the current issue will have some impact on our deliveries to some extent this year but it is solvable. Let's remember that the [indiscernible] (34:30) as manufactured and designed was approved through the FAA certification process. We are confident in that the parties will expeditiously resolve their dispute. Let's also – I think it's important to remember, this is really a terrific engine. It's quiet, its performance is superior and its highly efficient. So we will get through this.

A

Ronald J. Epstein

Analyst, Bank of America Merrill Lynch

So basically, I guess, is there any way you can give a – how disruptive could it be or not? Just kind of that kind of thing. Like, Phebe, everybody sort of worries about these things when they come up. And we've seen them come

Q

and go in the past and in the end, it don't usually amount to much. But if you could give people comfort on that, that would really be helpful.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

Yes, so this year, to the extent it affects some of the G500 deliveries, margins will go up and our earnings are going to be flat. So I'm pretty comfortable that we will get through this and the sooner we get through it, the better. But this is all solvable. And frankly, we can manage through this as can Pratt.

Ronald J. Epstein

Analyst, Bank of America Merrill Lynch

Q

Okay, okay, great. I'll leave it there and let someone else ask their question. Thank you.

Operator: And today's next question comes from Carter Copeland of Melius Research. Please go ahead.

Carter Copeland

Analyst, Melius Research LLC

Q

Hi, good morning, Phebe and Jason.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

Good morning.

Jason Wright Aiken

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

A

Good morning.

Carter Copeland

Analyst, Melius Research LLC

Q

I wanted to just ask a closely related two-parter here on G500, G600. You've commented recently about the impact on margins there as we look forward to next couple of years and my understanding is that's some non-recurring cost that you have to layer in on those initial production lots. How long does that stretch in terms of time that those impacts will be there for the G500 and G600? And then secondly, you talked about the G500 weighing on margins in the fourth quarter on those initial deliveries. Do you still expect those deliveries to be profitable, but still just dilutive to the overall Gulfstream or Aerospace margin? Thank you.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

Yes, they will be profitable. The first lot of airplanes tends to carry program costs that reduce margins. That said, we have always demonstrated superb operating performance in the manufacturing of our airplanes. So we will – as soon as we get through that, margins will ramp up very nicely on the G500 and G600.

Carter Copeland

Analyst, Melius Research LLC

Q

And does that happen in 2021?

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

It'll happen before that. We've just got to get through a handful of the G500s and off we go.

Operator: And today's next question comes from Robert Stallard of Vertical Research. Please go ahead.

Robert A. Stallard

Analyst, Vertical Research Partners LLC

Q

Thanks so much. Good morning.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

Good morning.

Robert A. Stallard

Analyst, Vertical Research Partners LLC

Q

Phebe, you mentioned that demand for the G650 is still very strong. I was wondering if you could give us some idea of what the current lead time is on that aircraft. And previously, you indicated that you might want to bring production down on that model. Is that still the case?

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

So we have begun to ramp down production on the G650 and will continue to do so, the pace at which, however, we're going to have to discern as we do our plans for 2019 because the order book has been so strong. So the G650 is doing frankly quite nicely. What was the first part of your question?

Robert A. Stallard

Analyst, Vertical Research Partners LLC

Q

The lead time, if I was to order one today.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

The lead time. So the lead times are well within our comfortable range of about 18 months. All of our airplanes are in a very comfortable range.

Robert A. Stallard

Analyst, Vertical Research Partners LLC

Q

That's great. Thank you very much.

Operator: And today's next question comes from David Strauss of Barclays. Please go ahead.

David Strauss

Analyst, Barclays Capital, Inc.

Q

Good morning.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

Hi, David.

A

David Strauss

Analyst, Barclays Capital, Inc.

Hey, Phebe. So I wanted to follow up. Jason made the comment about deleveraging from here. I guess you have \$2.5 billion in commercial papers. So can you talk about the pace at which you plan to delever? And then also on cash conversion, you touched on kind of mid-90s this year. What should we think about going forward given the high amortization levels associated with CSRA? Thanks.

Q

Jason Wright Aiken

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

Hey, David. I think what you can expect in terms of deleveraging is that commercial paper that you see on the balance sheet that should be gone by the end of the year and you'll see call it roughly similar reductions for the next couple of years following that, all consistent with the maturities in our existing ladder. So that will all come as scheduled on maturity.

A

With respect to free cash flow, we'll continue to target to be in the 90s to 100% range moving forward, all subject obviously as we've mentioned to investment for growth particularly in Marine Systems, but we'll continue to be in that 90s to 100% range as we look forward.

Operator: And today's next question comes from Seth Seifman of JPMorgan. Please go ahead.

Seth M. Seifman

Analyst, JPMorgan Securities LLC

Thanks very much and good morning. I just wanted to go back to some comments, Phebe, that you made a little bit earlier in the year and make sure I understand them in detail. I thought that maybe for 2019 and 2020 we were going to be looking at the Aerospace margins coming down 200 to 300 basis points from the 2018 baseline. And I want to see if that's still the case and if not what's changed?

Q

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

So, look, our margins are going to be just fine. I'm not going to get into 2019 and 2020. That will all depend on our build rate, but we are going to be quite comfortable in our margin performance as we frankly always are at Gulfstream. So I wouldn't give that too much worry.

A

Seth M. Seifman

Analyst, JPMorgan Securities LLC

Okay.

Q

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

There are going to be margin compressions because we got mix issue. That should be understood and fairly explicable. So we're in pretty good shape on that score.

A

Operator: And today's next question comes from Doug Harned of Bernstein. Please go ahead.

Douglas Stuart Harned

Analyst, Sanford C. Bernstein & Co. LLC

Q

Thank you. Good morning. Phebe, you talked about the strong demand signals you're seeing in the market right now at Gulfstream. Could you give us a little more insight into how that goes by geography, customer type? And just have to ask, are you seeing any impact from the coming introduction of the new Bombardier models?

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

So our order book is heavily North America with strong European interest and some increase in the Asia Pacific region, pretty consistent with the way – to the previous patterns of the order activity. Across the portfolio, the order book tends to be divided roughly in thirds by private company's high net worth individuals and public companies.

So, look, our backlog is very durable and we understand who's in it. Many of them have been longtime customers. And the order activity continues. I think I've told you before, we're not very concerned about that airplane. We continue to sell the G650 at a good rate and we have some compelling attributes not satisfied with the 7500, including better range at restricted airports and more range at speed. I'd recommend that perhaps some folks should do some product comparisons that could help illuminate our lack of concern on that score.

Operator: And today's next question comes from Sam Pearlstein of Wells Fargo. Please go ahead.

Samuel J. Pearlstein

Analyst, Wells Fargo Securities LLC

Q

Good morning. I was wondering, if you could talk a little about Combat Systems. Just trying to think about the balance as we go forward and I guess this is even beyond this year with the recapitalization in the U.S., which I typically think is somewhat lower margin, but also looks like we're seeing strength in European defense spending and how that plays out for ELS and just thinking about the margin mix and the growth as we go forward there.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

So we're very comfortable with the growth estimates that we gave you for our long range plan back in January and that those estimates are undergirded by exactly the elements that you note. Interestingly, I have been watching the army for a very long time and under the leadership of Secretary Esper and General Milley, we've seen a focus on modernization to an extent that arguably hasn't been seen since the 1980s when the Army fielded the Big Five and they're budgeting their resources to support their modernization plan. They've also been working with industry very closely, which is very wholesome as we work to ensure that they get the best of class technologies and capabilities.

So I'm very pleased with the demand signals coming out of the United States. The same is true in Europe. Our European Land Systems is growing at a nice rate and the book-to-bill in that whole business has been very wholesome. Combat, as I noted in my remarks, has been a growth engine for us for the last two years and will continue to be so. So, we like what we're seeing in Combat.

Operator: And our next question today comes from Cai von Rumohr of Cowen and Company. Please go ahead.

Cai von Rumohr

Analyst, Cowen & Co. LLC

Q

Yes. Thank you so much. So yesterday when Lockheed Martin reported they had a substantial increase in their revenue guidance for this year and they were making the point that they're seeing DoD kind of put new business under contract sooner than they had expected and early flow-through of the large Omnibus add-ons in the FY 2018 budget. Are you seeing any of that because you look like you have relatively modest revenue hikes for this year? So...

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

I thought we were...

Cai von Rumohr

Analyst, Cowen & Co. LLC

Q

...are your numbers conservative?

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

I thought we were growing nicely. Hey, look, I don't know what...

Cai von Rumohr

Analyst, Cowen & Co. LLC

Q

I didn't say you weren't growing nicely, but it looks like – I mean, I'm just asking is this kind of a conservative number so it may have upside or is this kind of right down the fairway? How should we think about that?

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

I never comment on others. I can simply tell you that our revenue estimates are very consistent – today, are pretty consistent with where we were when we set this plan. We have a great deal of insight into our customers and their spend rates. And I think it's certainly in Marine, that's very steady predictable growth. Right?

Combat is much the same way to the extent that we've seen some surprises, frankly, in the growth rate have been at CSRA and GDIT which grew very, very nicely. And we'll continue to do so and we've reflected that in our updated guidance. So no particular surprises here, frankly. We've been pretty forthright with you all on what we expected and that's what's happened and what is happening.

Cai von Rumohr

Analyst, Cowen & Co. LLC

Q

Terrific. Thank you very much.

Operator: And our next question today comes from George Shapiro with Shapiro Research. Please go ahead.

George D. Shapiro

Analyst, Shapiro Research LLC

Q

Yes. Good morning. Phebe, on Aerospace, the increase in revenues is primarily Hawker Pacific or were there additional deliveries? Could you provide what the updated deliveries might be? And then also on the margin with no G500 deliveries in the third quarter...

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

Whoa, I didn't say no. Go ahead. Yeah. Go ahead.

George D. Shapiro

Analyst, Shapiro Research LLC

Q

Okay. Sorry about that. The increase in Aerospace guidance is primarily from the acquisition of Hawker Pacific or there're increased deliveries as well? And then second part of it is, with no G500 deliveries in Q3, you should have another strong margin, would imply that the fourth quarter margin would be 15% or less. I mean, is that a fair characterization? Thanks.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

So as I mentioned to you, we may have a few G500 deliveries in the third quarter. We said consistently that that first lot of G500s is going to carry lower margin and our guidance to you reflects that. The increase in revenue is a combination of a lot of different elements in this very complex portfolio, Hawker, mix in deliveries, increased service, so across sort of the whole [ph] canopy (49:01) of levers that present in any given quarter. That is our best estimate right now. I'm pretty confident in it in terms of the revenue and the earnings, frankly.

George D. Shapiro

Analyst, Shapiro Research LLC

Q

Okay. I'll stick with the one question. Thanks.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

Thanks, George.

Operator: And our next question today comes from Joe DeNardi of Stifel. Please go ahead.

Joseph William DeNardi

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Yeah, thank you. Phebe, I was wondering if you could talk about Marine longer term and what your expectations are there from a margin standpoint and what your mix of work is going to be on Columbia versus Virginia class, what your current line of thinking there is? Thank you.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

So think about large shipbuilding programs and businesses is typically having margins in the 8% to 10% range depending on the maturity of the program. So that's the prism through which we should look at the Marine Group.

That said, as we ramp up on Columbia, we will see some margin compression quite naturally because that will be cost plus work. And given the long duration of the shipbuilding contracts and the shipbuilding process itself for any one of these single submarines, that margin compression can obtain for a while offset, of course, by increased improvements in our Virginia class performance which we have historically shown.

So I don't have a good estimate right now for you of the out year estimate on the mix between Virginia and Columbia. Columbia will, in seven or eight years, completely dwarf or heavily dwarf Virginia. So it's simply because of the volume coming into the yard. Think about it this way, we start manufacture of that first Columbia in 20 and then it will ramp up pretty expeditiously through the next four or five years.

So we'll be able as we – I think I mentioned from time ago, we signed last year a detailed design contract. Part of that contract is a detailed plan that we worked out with the Navy on exactly the sequencing of the requirements and the build strategy and the funding to go along with that. Once we get that ironed out in the next year and a half to two years, then we'll have quite a bit of clarity on exactly what this very long range program looks like.

Joseph William DeNardi

Analyst, Stifel, Nicolaus & Co., Inc.

Thank you.

Q

Operator: And our next question today comes from Peter Arment of Baird. Please go ahead.

Peter J. Arment

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

Thanks. Good morning, Phebe and Jason. Phebe, just on CSRA, it sounds like it's nicely accretive. Can you maybe update your thoughts on how you're thinking about still the synergies? And I know there's some costs that you get to hold on or some cost reduction you get to hold on to and some you give back. But how are you thinking about that now that you've had the business for a few months?

Q

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

So our costs and savings have baked into our estimates for the year. And with respect to CSRA, our integration is going very, very well. We're right on target, in fact, a little ahead of schedule. I suspect we will continue to see increased synergies over time. The beauty of putting these two businesses together is we can take the best-in-class out of GDIT in the best-in-class out of legacy CSRA and really marry those capabilities for some pretty impressive performance in the marketplace.

A

The combined GDIT under the new GDIT has had a 75% win rate this year. That is pretty darn impressive for a highly competitive business. So I think that speaks to the power of the combination of these two businesses.

Peter J. Arment

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

Thank you.

Q

Operator: And our next question today comes from Sheila Kahyaoglu of Jefferies. Please go ahead.

Sheila Kahyaoglu

Analyst, Jefferies LLC

Q

Hi. Good morning, everyone. And thank you.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

Good morning.

Sheila Kahyaoglu

Analyst, Jefferies LLC

Q

Good morning. Just sticking on CSRA, can you maybe elaborate how we should think about retention rates for that business whether it's the employee base or just contract renewals? And Phebe, if you could just expand a little bit about the integration targets you mentioned.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

A

So we have added about \$900 million in this quarter alone to – over \$900 million in our backlog on the combined contracts. With respect to employees, we have retained every single employee that we have wanted to retain. And the beauty of this integration is that we're taking the management team of CSRA and the management team of GDIT and we have melded it into a very, very effective, cohesive management team with a vision on how they want to proceed.

They are melding the two cultures. They are bringing the best-in-class technical capabilities in each business and the customer intimacy in each business. So we're very pleased with our employee retention. We've had super contract generation. There have been frankly no surprises or disappointments in any of the contract activity since the acquisition.

It's interesting, just to give you a little bit of perspective on this. GDIT grew 9% and, for the quarter, CSRA grew 12.6% and that's the particularly impressive given their 9% growth in the quarter prior to the acquisition. These businesses are doing extremely well.

Howard Alan Rubel

Vice President-Investor Relations, General Dynamics Corp.

A

So we'll take one last question, operator.

Operator: Absolutely. Our last question comes from Rob Spingarn of Credit Suisse. Please go ahead.

Robert M. Spingarn

Analyst, Credit Suisse Securities (USA) LLC

Q

Good morning. I don't know if this is, Phebe, for you or Jason, but I wanted to try and get at normalized margins in Aero and in GDIT just given the somewhat unusual moving pieces in the back end of the year here. So while I know you don't want to talk about 2019, once we get past this early lot of G500s and I'd ask you how many aircraft are in that lot. How do we think about it? Does Aerospace get back to a 20% margin whenever that time is?

And then similar question on GDIT, how do we think about normalized margins there? Can CSRA get back to legacy GD levels or even higher?

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

Yeah, Jason will address that.

Jason Wright Aiken

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

Let me take the CSRA, GDIT side. I think the way we're looking at it is if you adjust for the amortization impact, the incremental amortization from the transaction, CSRA is actually contributing margins consistent with their historic performance, double-digit performance and is accretive to the margins of the group, again ex that amortization.

And a point on that, I noted in the remarks that we had – we're anticipating \$190 million of amortization this year for the CSRA transaction. Under the accounting rules, that's actually an accelerated message. So we'll have \$190 million for the nine months of this year followed by, I think, it's 200 million next year and then it'll ratchet down over time.

So you'll see that in a little more detail in the 10-Q we'll publish later today. But that will, I think, help you sort of model impacts on margin rates, if you think of core CSRA contribution ex amortization in the double-digit range consistent with their history. So that's sort of the story on the GDIT side.

Phebe N. Novakovic

Chairman & Chief Executive Officer, General Dynamics Corp.

On Gulfstream, so one of the things that you should by now think about us as a superb operating company. So we'll get through the initial lot, fairly expeditiously and you may ask the number in that lot, but I don't intend to tell you.

And then begin our ramp down our learning curve. We've got synergies between the G500 and G600 lines because they are coproduced in the same facility. I'm not going to be predictive of how good can we get in the out years. But you can believe year in and year out, we will improve our performance on our airplanes.

Howard Alan Rubel

Vice President-Investor Relations, General Dynamics Corp.

Thank you, Phebe and Jason, and everybody else who was listening today. This ends our call. If you have any additional questions, I can be reached at 703-876-3117. With that, we look forward to talking to you later today and in the days ahead. Goodbye.

Operator: Thank you. The conference is now concluded. Thank you all for attending today's presentation. You may now disconnect.

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