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OVERVIEW:

Company Summary

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to Northrop Grumman's second-quarter 2024 conference call. Today's call is being recorded. My name is Josh, and I will be your operator today. (Operator Instructions)

I would now like to turn the call over to your host, Mr. Todd Ernst, Vice President, Investor Relations. Mr. Ernst, please proceed.

Todd Ernst - *Northrop Grumman Corporation - VP of Investor Relations*

Thanks, Josh, and good morning, everyone. And welcome to Northrop Grumman's second-quarter 2024 conference call.

Before we start, matters discussed on today's call, including guidance and outlooks for 2024 and beyond, reflect the company's judgment based on information available at the time of this call. They constitute forward-looking statements pursuant to safe harbor provisions of federal securities laws.

Forward-looking statements involve risks and uncertainties, including those noted in today's press release and our SEC filings. These risks and uncertainties may cause actual company results to differ materially.

Today's call will include non-GAAP financial measures that are reconciled to our GAAP results in our earnings release. And also, we will refer to a presentation that is posted on our Investor Relations website.

On the call today are Kathy Warden, our Chair, CEO and President; and Dave Keffer, our CFO. At this time, I'd like to turn the call over to Kathy. Kathy?

Kathy J. Warden - *Northrop Grumman Corporation - Chair, CEO & President*

Thanks, Todd. Good morning, everyone. Thank you for joining us. As you saw from this morning's earnings release, we delivered excellent operating results again this quarter, building on our momentum from the first quarter.

Our company's ability to respond to U.S. and international customer requirements with a wide range of advanced capabilities continues to drive strong growth, with sales up 7% in the quarter and 8% year to date. And our team's solid program performance, along with cost management discipline, led to operating income growth of 13% in the second quarter.

The combined strength of our top and bottom-line operating results was the primary driver of our 19% EPS growth. And in addition, we delivered robust free cash flow, which is up over $500 million compared to the first half of last year. Based on these strong first half results and confidence in our team's ability to deliver on continued robust demand in the second half, we are increasing our 2024 revenue and EPS guidance.

The breadth and depth of our portfolio is an important differentiator, particularly when coupled with the effectiveness of our strategy in aligning our resources to anticipate and deliver on our customers' needs. Given this, I'm going to take the next couple of minutes to provide important context on our portfolio.

When you step back and look at the key components of our business, you'll see that 85% of our sales come from a diverse collection of technology-advanced capabilities, such as electronics, communications, crewed and uncrewed aircraft, space payloads, advanced weapons, command and control systems, and other product areas which are critical to global security.

The capabilities we provide, often as a supplier, are in the nation's most advanced space, air, land, sea, and undersea platforms. In the last several years, we've been selected through dozens of competitions to develop and build differentiating technologies that will provide an advantage to the U.S. and our allies through the 2030s.

The remaining 15% of our sales is comprised of two prime programs in support of the nation's strategic deterrent -- of course, that's Sentinel and B-21 -- with each generating a high single-digit percentage of our revenue today, and we expect that balance to continue for several years. With the recent realignment of our SDS division to our Defense Systems sector, we have four strong and differentiated Segments that are more equal in size, with each having multiple avenues for profitable growth.

Our business is well aligned with the U.S. National Defense strategy. And as I've outlined, in recent years, we've won significant roles on long-term programs that address the threat environment of today and are expected to do so for the next several decades. In addition, we continue to expand our exportable product offerings, and we are developing our international partner and supplier base to position us for the growing international markets.

We have also invested to increase our capacity to deliver the quantities of rocket motors, armaments, and air and missile defense capabilities needed by the U.S. and our allies to defend freedom and deter aggression around the globe. Examples of this growth include the Guided Multiple Launch Rocket System, or GMLRS, where our year-to-date revenue has grown by nearly 60%.

Additionally, we were awarded over $500 million in contracts for ammunition that we will begin delivering in the third quarter. And we see additional demand for international ammunition opportunities in the coming quarters.

Overall, the key takeaway is that the breadth of our portfolio, our alignment to the key priorities for the U.S. and our allies, and our role on each leg of the U.S. Strategic Triad provides us visibility into avenues for our business to grow even if U.S. budget growth slows. And as we've discussed frequently, over the last two years, we're not just focused on top line growth. We're taking deliberate actions to enhance profitability through digital enablement, productivity, supplier management, and cost efficiency.

As we look at the remainder of this year and next, we expect solid growth across the portfolio to continue, particularly in areas such as weapon systems, advanced electronics, and aeronautics. International sales are also progressing from our pipeline to our backlog and are expected to contribute to increased sales and profitability.

Our outlook is supported by the national security spending environment. In the U.S., the fiscal year 2025 Defense Budget is moving through the appropriations process with recent markups by Congress. We were pleased to see the Senate Armed Services Committee increase the FY25 top line by $25 billion, and we're encouraged by continued support for investment in Defense.

Northrop Grumman's programs broadly, and particularly the B-21, Sentinel and Columbia, which provide the basis for the U.S. Strategic Deterrent, continue to receive strong support, bolstering our view that we're well-positioned in this budget environment. Given the importance of the Triad to the Nation's Deterrence, I'll provide an update on two legs of the Triad for which Northrop Grumman is the prime industry partner to the Department of Defense.

So starting with Sentinel. Earlier this month, the DoD submitted to Congress certification of the Sentinel program as part of the Nunn-McCurdy process. This certification validates the need for the land-based leg of the Triad and continued confidence in the Sentinel weapon system for the critical role it plays in safeguarding global security.

DoD and the Air Force are working to restructure the program to reflect the latest cost and schedule estimates. The majority of the cost growth is expected to occur in the production phase of the program, which is beyond the current EMD phase and outside of the Future Years Defense Program, or FYDP.

We continue to execute on our existing EMD contract, which includes the design, development, and testing of the full system. We are partnered with the Air Force on completing the design of all aspects of the system and have many of the system's components already in development and test, including all three stages of the missile, command and launch subsystems for launch activation, security and systems monitoring, as well as transportation and support equipment.

The progress we've made on the program is significant, and we remain committed to partnering with the U.S. Air Force to identify ways to reduce the costs associated with fielding this system.

So turning to the air leg of the triad. The B-21 is progressing well through the testing program and, as you know, has entered low rate initial production. The team continues to perform exceptionally well, and we remain within our schedule and cost estimates.

As we recently shared, B-21 test pilots report that the aircraft is flying like the simulator, which is another indication that our digital environment has effectively predicted the performance of the aircraft, thus reducing new discovery and risk. For these reasons and more, we continue to believe in the significant value this program will create for customers and shareholders over time.

It's important to note that while the B-21 program is very important, it contributes less than 10% of our total sales. And we expect that to remain the case through the decade. Assuming stable economic conditions and continued strong performance by our team, we also expect program margin dollars to grow annually from here as we complete the EMD program and first five lots of production, move into advanced production awards on the more profitable lot 6 and beyond, and add modernization and sustainment revenue to the program.

As you can see, our portfolio includes a compelling mix of technology-driven capabilities and franchise programs that are well aligned to the evolving needs of all of our customers. As a result, we've grown our organic revenue at greater than 5% compound annual growth over the past five years, including 5% growth projected in our increased 2024 guidance.

We also continue to rapidly expand our cash flows, including generating over $1 billion of free cash in the second quarter. Based on the strength of our portfolio, backlog, and performance trends, we are reiterating our long-term cash flow outlook, which assumes a greater than 15% compound annual growth rate through 2026.

To support growth in our business, we're maintaining our investments and capabilities across the company. We continue to target $1.8 billion in capital expenditures this year, which is around 4.5% of revenue and well above the industry average.

Including R&D, we're investing approximately $3 billion in our portfolio. At the same time, we're efficiently returning capital to shareholders, including $2.3 billion in the first half of the year. In May, we increased the dividend by 10%. This is our 21st consecutive annual increase as we continue to focus on delivering competitive sustainable dividend growth.

Before I turn the call over to Dave to provide more details on our financial performance and outlook, I'd like to thank our team for another great quarter as we continue to execute on our long-term strategy. We have an outstanding portfolio, a high-performing team, and a bright outlook for the future.

So with that, I'm going to turn the call over to Dave.

David Keffer - *Northrop Grumman Corporation - CFO, Corporate VP*

Thanks, Kathy, and good morning, everyone. Before covering our Q2 results and outlook, I'd like to take a moment and provide some context around our financials, given the recent segment realignment.

As Kathy noted, the Strategic Deterrent Systems division, which includes Sentinel and other related programs, moved from our Space Systems segment to our Defense Systems segment effective July 1st. Second quarter results have been reported in the prior organizational structure, given the effective date of the realignment, but we've provided a table in the earnings release and earnings slides that recasts sales and margin for current and historical periods under the new organizational structure.

Moving forward, we will report third quarter results and beyond under the new structure. And our updated financial guidance is also under the new structure. So with that, let's get into our second-quarter results.

Starting with demand, Q2 net awards totaled over $15 billion, generating a book-to-bill ratio of 1.5 times and increasing our backlog to over $83 billion. As a result of our strong year-to-date performance, we now expect a full-year book-to-bill ratio of more than 1 times sales.

Turning to our top-line results on slide 4 in our earnings deck, second-quarter sales were $10.2 billion, an increase of 7% compared to the same period in 2023. All four segments generated year-over-year growth again in Q2. Looking ahead to the second half of the year, we expect a gradual ramp in our quarterly sales profile, with Q3 sales projected to be roughly in line with Q2.

Aeronautics second-quarter sales increased by 14% with similar drivers to Q1. Higher volume on B-21, F-35, and Triton again led the way. At DS, sales grew by 7%, primarily due to higher volume on certain military ammunition programs and higher volume from the timing of materials on GMLRS.

Mission Systems sales increased by 5%, with continued strong growth on advanced microelectronics programs, our marine systems portfolio, and SEWIP. And at Space, sales were up by 2%, driven by growth on the SDA Transport Layer programs and GEM-63 solid rocket motors, partially offset by lower sales in the restricted space portfolio.

Bottom-line results were also very strong, with segment operating income up 5% year-over-year and total operating income up 13%. These results reflect another solid quarter of overall program performance as well as lower corporate unallocated expense.

AS operating income grew by 6%, generating an operating margin rate of 10% for the second straight quarter. These results have provided an example of how strong program performance, focused productivity initiatives, and indirect cost efficiencies can generate margin rates at these levels even as we ramp on B-21.

Speaking of B-21, there were no significant changes to our LRIP EAC again this quarter. There are currently 21 aircraft in baseline for the first five LRIP lots and another 19 production aircraft subsequent to these for which we have "not to exceed", or NTE, pricing.

These prices were set in 2018, and given that the production for those lots was well into the future, the average unit NTE price was set above the average LRIP price. The NTE lots include an economic price adjustment clause to protect against certain inflationary pressures.

Pricing, final quantities, and terms and conditions have yet to be fully negotiated for these additional aircraft. Based on our current projections, we expect to be able to execute the NTE lots profitably.

As you think about the trajectory of the overall program, we expect to begin work on long-lead items related to the NTE lots in 2026. Overall production will continue to ramp through the second half of the decade. And we expect that production sales will become larger than EMD beginning in 2026.

Other B-21 efforts for modernization and sustainment will also begin to grow over the next couple of years and are expected to generate profit rates that are accretive to the overall program. Taking all these factors together, we currently project that margin dollars for the overall program will gradually expand going forward, as Kathy outlined.

Defense Systems had a particularly strong quarter, with operating income up 23% and a margin rate of 13.5%. Higher net EAC adjustments and favorable changes in contract mix contributed to their significant year-over-year improvement.

At Mission Systems, operating margin rate was 13%, which was lower than Q2 of last year. Similar to Q1, this was a result of lower net EAC adjustments and changes in contract mix towards more cost-type contracts.

While margin rates at current levels remain very competitive, they are below MS's historical performance, and we continue to see opportunities to improve margins in the second half of the year. These improvements will be driven by continued investments we're making in our factories to improve performance and increase production volumes as well as from the business mix shifting to more fixed price work.

Space had another solid quarter of operating performance, with operating income increasing 14% from the prior year, generating a margin rate of 9.1%. We've seen improvements in Space program performance for multiple quarters now as a result of deliberate actions we've taken in the business.

Moving to earnings per share on slide 6, Q2 diluted EPS was $6.36. This represents an increase of 19% from the prior year, driven by continued strong growth in segment performance as well as from higher net pension income and lower corporate unallocated expense.

Rounding out our Q2 results is cash flow. We had an excellent quarter of cash generation with Q2 free cash flow of $1.1 billion, up 80% compared to our results from Q2 of last year, and on track with our expectations for the full year. We returned approximately $900 million to investors in Q2 via dividends and share repurchases, while also continuing to make strategic investments in our business.

Slide 7 includes our latest segment guidance based on our new organizational structure. We are increasing our sales guidance at both AS and MS, neither of which were affected by the sector realignment. AS is now projected in the high $11 billions, and MS is projected in the mid-$11 billions.

The increases are driven by the strength of their year-to-date results and expectations for the rest of the year. As we indicated on our Q1 call, Aeronautics sales are expected to flatten out in the second half of the year based on timing of materials and production schedules.

We've also updated our margin expectations for AS and MS. We now expect a margin rate at Aeronautics of mid to high 9%, reflecting their ability to generate strong margins across their mix of mature production programs and early-stage development programs. The increase at AS offsets the decrease in margin rate at MS, which is now projected at low to mid 14%.

At DS, we've increased our sales guidance this year to roughly $9 billion. This reflects the realignment of the SDS division to DS, which is expected to generate sales this year of roughly $2.7 billion. The increase also reflects our expectations for higher sales volume associated with ammunition and weapons replenishment.

We expect Space sales to be relatively flat this year, projected in the mid- to high $11 billion range, and to be down somewhat in 2025. This profile is driven by the removal of NGI and a restricted program during 2024, which collectively had a run rate of about $1.5 billion in annualized sales. Those headwinds affect both this year and next, of which the larger impact will be experienced in 2025.

We expect the rest of the Space portfolio to continue to grow. Overall, we expect a relatively stable level of margin dollars in Space in 2025 as the margin rate grows and offsets pressure from lower volume.

Space's guidance also reflects higher intercompany sales primarily associated with propulsion activities in support of the Sentinel program. This also has the effect of increasing company-level eliminations to roughly $2.7 billion.

We expect a margin rate at DS of approximately 10% this year and a low 10% rate at Space given the shifts in the portfolio. In total, we now expect company-level sales of $41 billion to $41.4 billion, representing 5% growth at the midpoint. We continue to expect segment OM dollars to grow at roughly the same rate as sales.

We've lowered our expectations for corporate unallocated expense to $150 million based on year-to-date trends. We continue to expect corporate unallocated expense to be weighted toward the second half of the year, consistent with prior years.

We've increased our expectation for the federal tax rate to the mid-17% and slightly lowered our expectation for interest expense to roughly $650 million. As we've noted in prior quarters, we're monitoring for any favorable or unfavorable updates in tax legislation, audits, and appeals processes that, by their nature, are not factored into our guidance.

And based on the latest plans for a higher volume of share repurchases, we've lowered our estimate for weighted average shares outstanding to the mid 147 millions. Altogether, our strong performance and outlook results in an increase of $0.45 to our diluted EPS range. We had a strong first half of the year, and we're looking forward to continuing to create value in the second half and beyond.

So with that, let's open up the call for questions.

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions) Kristine Liwag, Morgan Stanley.

Kristine Liwag - *Morgan Stanley - Analyst*

Hey. Good morning, Kathy and Dave.

Kathy J. Warden - *Northrop Grumman Corporation - Chair, CEO & President*

Good morning.

Kristine Liwag - *Morgan Stanley - Analyst*

I want to understand a little better the 19 B-21s under a not to exceed pricing agreement. I mean, I understand that the ceiling for the average unit price is higher than the first 21 aircraft. But how do we get comfortable that these next 19 aircraft are indeed profitable as final pricing is yet to be determined?

And then also as a follow-up, I think you both mentioned that lot 6 is more profitable. I just want to clarify, does this mean absolute positive margin on the program? And -- or is that a relative comment to the previous lots? I just want to understand the dynamics a little bit better on the B-21. Thank you.

David Keffer - *Northrop Grumman Corporation - CFO, Corporate VP*

Sure, Kristine, happy to clarify a few of those points. As you've noted, the NTE lots that follow the first five LRIP lots are currently projected to be more profitable than the LRIP lots. And to clarify that further, we are projecting a positive profit rate in lot 6 based on our current projections.

So to your point, those NTE prices are set higher than the prices that are expected for the first five lots. And with cost efficiencies that we're working hard to drive and program performance and productivity efforts very much in progress, our current projections indicate positive profitability for those lots.

Operator

Thank you. Scott Deuschle, Deutsche Bank.

Scott Deuschle - *Deutsche Bank - Analyst*

Hey, good morning. Thanks for taking the question.

Kathy J. Warden - *Northrop Grumman Corporation - Chair, CEO & President*

Morning, Scott.

Scott Deuschle - *Deutsche Bank - Analyst*

Dave, just to follow-up on Kristine's question. Is the difference on B-21 units 22 to 40 that they have both a higher average base price and the EPA cost protection, or do units 1 to 22 also have that EPA protection?

David Keffer - *Northrop Grumman Corporation - CFO, Corporate VP*

The -- I think you're right, those are both important points about the NTE lots, that they are set higher. They also do include an EPA clause. That is one we're monitoring carefully. So both are important to keep in mind as eventual pricing and terms and quantities are finalized for those portions of the program.

Scott Deuschle - *Deutsche Bank - Analyst*

Okay. Great. And then, Kathy, there was a news article a while back about the issue the industry faces in sourcing ammonium percolate for making solid rocket motors. Is that something you guys have made some good headway on? And based on your comment on GMLRS output being up 60%, it sounds like the answer is yes, but just curious for your perspective. Thanks.

Kathy J. Warden - *Northrop Grumman Corporation - Chair, CEO & President*

Yes, Scott. Thank you for the question. We did recognize this as a constraining factor in our supply chain for solid rocket motors four or five years ago. And the team brought forward a business case, which we funded to create an alternate supply. And we have done so, which gives us more confidence in our ability to manage that supply.

We also, of course, are buying AP from other sources as well. We are not the single supplier of our own AP, but we did add to the overall production capacity, which has improved our ability for predictability on SRMs, solid rocket motors.

Operator

Thank you. Rob Stallard, Vertical Research.

Rob Stallard - *Vertical Research Partners - Analyst*

Thanks so much. Good morning.

Kathy J. Warden - *Northrop Grumman Corporation - Chair, CEO & President*

Good morning.

Rob Stallard - *Vertical Research Partners - Analyst*

Kathy, on Sentinel, there's been some reports that the customer is not happy with the way this program has been progressing so far. And I was wondering, first of all, what sort of risk is there that Northrop could be on the hook for additional charges on this program? And then secondly, what you're trying to do practically to improve the cost profile on Sentinel? Thank you.

Kathy J. Warden - *Northrop Grumman Corporation - Chair, CEO & President*

Yeah. Well, thank you. The DoD did a thorough review of the program as part of the Nunn-McCurdy process, and they were very transparent about the results of that review. For those of you who haven't seen it, they did a press release, they conducted media interviews about 1.5 weeks ago to share those results, and they met with many members of Congress.

And in that process, they have not pointed to industry performance as the cause of cost growth. The things that they have pointed to include inflation, obviously, particularly as we look at deployment cost -- there's a big construction component of this job -- and also the assumptions that were made many years ago that underestimated the complexity of the program. Those were the two primary costs growth drivers that were identified.

We are working with the Air Force to identify ways to perform better than those cost growth estimates, and we will continue to do that. We are looking at everything from design alternatives that they have referenced in the restructure of the program to ensuring we have the right team in place to execute on every part of the program in that deployment and production phase.

And of course, we are continuing to bolster our own staff and systems engineering on the program. But the reality is that most aspects of the program are progressing very well, and the Air Force has publicly made those comments. We are very focused on the ground infrastructure, which is the piece of the program that is driving the vast majority of the cost growth, and that's what our focus will continue to be through the restructure.

Rob Stallard - *Vertical Research Partners - Analyst*

Thanks so much.

Operator

Thank you. Jason Gursky, Citi.

Jason Gursky - *Citi - Analyst*

Yeah, Kathy, just a quick follow-up to that last commentary. There was an article yesterday with some comments from somebody up on the Hill, a senator, I think, that did mention Northrop. So I'm just kind of curious if we can get some context about your recent visit? It sounds like you made up to the Hill -- and why you'd have somebody in Congress making some comments that are a little bit contrary to what you just mentioned.

Kathy J. Warden - *Northrop Grumman Corporation - Chair, CEO & President*

Well, I'm not going to comment on any individual meeting that I had. But I have had a number of meetings with members of Congress on both sides of the aisle, and they have generally been very supportive of the need for the program and our team's role in that program.

And I will also just note that the Department of Defense did speak for the program and their findings on the Nunn-McCurdy, and have spoken very clearly about that. The final thing I'll suggest is that while not everyone is a supporter of the land-based leg of the triad, you can look at the vote and the appropriations, which have fully funded the program; and it's more reflective of the landscape I painted, which is broad-based Congressional support for the program and our role in it.

Jason Gursky - *Citi - Analyst*

That's helpful. Thank you.

Operator

Thank you. Sheila Kahyaoglu, Jefferies.

Sheila Kahyaoglu - *Jefferies - Analyst*

Good morning, Kathy and Dave. Thank you -- and Todd. Maybe if we could just talk about your Mission Systems business. It's been a solid double-digit business, and you stepped down this quarter. How do we think about that mix impact, lower EACs?

And there's 100 basis points of ramp in the second half versus H1. How does that evolve? And how do we think about that longer term?

David Keffer - *Northrop Grumman Corporation - CFO, Corporate VP*

The way I would characterize that is -- I think, first of all, you've touched on a key point, that the mix in MS has shifted over the last few years to be more heavily cost-type in nature. We think that mix will shift back in the direction of more fixed price work over the next several years.

A lot of the growth in MS in recent years has been large, cost-type development programs, leading technology efforts across its multiple mission areas. And as a result, its cost-type mix has gone from the mid-30s% back in 2021 to the mid-40s% this year.

Gradually, that will shift downward over time to include the second half of this year when, consistent with last year, some of our greater sales volume in the second half in MS will be driven by programs that are more predominantly fixed price in nature. And that will blend the mix upward even as soon as the second half of this year.

But I think another important point is the set of deliberate actions we're taking to improve productivity and performance and cost efficiency in our Mission Systems business as we're scaling to meet increased demand in our factories. And improvements there are being felt already in the business and are another driver of our confidence in second half margins for MS being higher than those we've delivered in the first half.

We're working closely with our suppliers and our production teams in MS to continue to deliver on those efforts and expect progress in the second half and beyond.

Sheila Kahyaoglu - *Jefferies - Analyst*

Thank you.

Operator

Thank you. Seth Seifman, JPMorgan.

Seth Seifman - *JPMorgan - Analyst*

Thanks very much and good morning. I wanted to dig in a little bit on the Space decline you talked about for next year. It looks like off of the revised numbers, maybe it's a modest decline this year.

When we think about what's coming next year and the ability to grow in -- I think you talked earlier, Kathy, about growing again in 2025, the ability to grow in 2025 relative to the 5% growth rate that you're expecting for this year. Is it possible to make any comments about that at this point?

Kathy J. Warden - *Northrop Grumman Corporation - Chair, CEO & President*

Sure. With the increase in our guidance this quarter, we expect 5% growth again this year following a period, as I said, of about 5% compound annual growth for the last five years. So, looking forward, we'd expect solid growth across three of our four segments with the strong demand that I talked about earlier in the call, balanced across the portfolio.

Space is likely to be the exception to that next year. We are guiding around flat this year and down modestly next. And that's due largely to the impact of NGI and the restricted program that we talked about earlier this year being canceled. And then we do expect Space to return to growth in 2026.

So it's too soon to provide a detailed guide for 2025 at a company level, but that gives you a sense of the dynamics that we're expecting in the various segments. And with the broad-based portfolio that we have, the slight decline that we expect in sales in Space next year do not change our outlook for the company as a whole.

Seth Seifman - *JPMorgan - Analyst*

Okay. Okay. Thanks. And then maybe as a quick follow-up. In Aeronautics, we've seen some fairly strong margin performance early this year and led to the guidance increase. I guess, are there specific things to point to for the second half that will pull that down below 10%?

David Keffer - *Northrop Grumman Corporation - CFO, Corporate VP*

Sure, Seth, happy to comment on that further. To your point, it was a really solid first half of the year and a solid second quarter for the AS business. Both top and bottom-line performance were strong.

And really, since the beginning of the year, we've been projecting and noting that the sales growth rate would moderate a bit in the second half of the year because of the timing of top line-items in Aeronautics, supplier deliveries and such, both on B-21 and on programs like F-35 that were going to lead to higher volume in the first half of the year than we saw a year ago. So that's where we've seen the really strong year-over-year growth rates in the first half.

We've been able to increase our guide for both sales and margin rate for the year. But to your point, it will involve slightly slower growth and slightly lower margin rates in the second half.

We have initially guided 9.5% for the year and have now increased that rate because of the first two quarters at 10%. So, we're continuing to project a really strong rate for the year. And I think that's evidence of the fact that we have a diversified mix of programs in AS. And programs like our support for F-35 as well as Triton, E-2D, and others are in healthy production levels where we're doing a great job for our customers and delivering strong results for investors.

Operator

Thank you. Gavin Parsons, UBS.

Gavin Parsons - *UBS - Analyst*

Thanks. Morning.

Kathy J. Warden - *Northrop Grumman Corporation - Chair, CEO & President*

Good morning.

Gavin Parsons - *UBS - Analyst*

I appreciate all the detail on B-21. That's really helpful, especially in terms of EBIT dollars growth. When do you foresee the peak margin rate headwind occurring from that program?

Kathy J. Warden - *Northrop Grumman Corporation - Chair, CEO & President*

So Gavin, what we have shared today suggests that our modeling of the program would see increased dollar growth from here on earnings, and modest sales growth. So you can anticipate, even though we didn't specifically outline it, that we are at the trough of margin rate performance on the program in our current modeling.

Gavin Parsons - *UBS - Analyst*

Got it. That's helpful. Thanks. And then I guess on the expectation for equitable adjustments on lot 6 or beyond, I think there was some expectation that there might be one on the first five LRIPs. Is it more contractual now on the forward expectation?

Kathy J. Warden - *Northrop Grumman Corporation - Chair, CEO & President*

So the difference with the NTE pricing is that the pricing itself has an economic price adjustment clause in it for the EPA contracts, which, of course, we have not negotiated or definitized. The LRIP did not have an EPA clause. So any inflation relief that we get on those contracts is additive to the terms.

Operator

Thank you. Cai von Rumohr, TD Cowen.

Cai von Rumohr - *TD Cowen - Analyst*

Thanks so much. So help me understand on B-21. I mean you took close to a $1.6 billion charge over five lots. That's roughly $300 million a lot. So I assume that's moving from about zero last year up to $300 million, negative. How do you get enough profit to offset that? Or when you talk about profit dollars improving, are you talking from an accrued basis where you've taken the charge already?

David Keffer - *Northrop Grumman Corporation - CFO, Corporate VP*

Right. Cai, it's the latter. We took that charge last year. So we're talking about the anticipated results from the program going forward.

Cai von Rumohr - *TD Cowen - Analyst*

Got it. Thank you very much. And then secondly, they're talking about restructuring the Sentinel program. Is that likely to be, in your opinion, Kathy, an opportunity or a risk for Northrop Grumman?

Kathy J. Warden - *Northrop Grumman Corporation - Chair, CEO & President*

At this point, Cai, what I would say is that the cost growth that is being talked about and which drove the Nunn-McCurdy is mostly outside of the EMD phase of the program, which, of course, is what we are on contract for and, therefore, what our financial projections reflect. And we do reflect the modest cost growth that we're expecting in the EMD contract in our financials, so you see that reflected in the Q2 booking rate.

And I would say we've taken a cautious approach on our booking rate at this point as we normally do at the beginning of a program. And as we perform and achieve more percentage -- performance milestones over the course of the program, we would expect that booking rate to improve.

Operator

Thank you. Doug Harned, Bernstein.

Doug Harned - *Bernstein - Analyst*

Good morning. Thank you. Kathy, when you talked -- you had a really big quarter this year for bookings after -- last quarter was pretty soft. And you're looking at being above 1.0 for the year. How should we think about the outlook this year in terms of bookings?

And I'd say in two dimensions. One is growth, U.S. versus international. And then second, which segments are we looking at where you expect to see that over the -- see some good growth over the next two quarters?

Kathy J. Warden - *Northrop Grumman Corporation - Chair, CEO & President*

Yes. So as Dave said, we are now expecting book-to-bill in the year over 1 after a very strong second quarter. We do see lumpiness in awards, as we've talked about before but consistently have been performing on an annual basis with book-to-bill over 1.

And this year, it is again expected to be reflecting our mix of domestic versus international sales. Because awards are going to be strong in both categories, with international bookings being stronger this year than they have been in the past and domestic bookings remaining strong.

In terms of the segments that are going to drive that, we've seen it shift more to our shorter-cycle businesses. So the strong bookings are more concentrated now in our new Defense Systems and in Mission Systems than they are in AS and Space.

But of course, I'll point that in both those segments, we've had strong -- they've been the key driver of strong bookings in the past. And so they still have a really solid backlog.

Doug Harned - *Bernstein - Analyst*

Yeah. I guess part of what I was getting at is if you're looking at -- we're looking at still unfortunately fairly flat budgets in the US, but a lot of growth outside. Should we expect to see over the next couple of years any kind of a shift in mix with a higher percentage of international sales?

Kathy J. Warden - *Northrop Grumman Corporation - Chair, CEO & President*

I would say we are seeing more international sales, and we are expecting our international sales to grow at a faster rate than our domestic. But also, when you look at bookings and the strength of our alignment with the National Defense Strategy and the prioritization, particularly of the Triad, and the growth that we expect on all three of those programs as they move through development and into production, we do believe that they will be well supported in the budget.

And we'll see them take more share of the budget overall. Even though each one of them is well below 1% of the overall DoD budget, they are well prioritized within the spending profile.

Operator

Thank you. Myles Walton, Wolfe Research.

Myles Walton - *Wolfe Research - Analyst*

Thanks. Good morning. Just had a quick follow-up question for you, Kathy. In your remarks earlier in the prepared remarks, you talked about high single-digit percentage of revenue on the Sentinel and B-21 and staying consistent with that over the next several years. And I guess I was expecting that the B-21 would trip into double digits within that time period, understanding that Sentinel might have a smoother or slower growth rate. Is that correct or incorrect in this assessment?

Kathy J. Warden - *Northrop Grumman Corporation - Chair, CEO & President*

No. And it's why we included it to clarify that even though you see budget profile from the Department that shows growth, that includes things that aren't on our contract as the government needs to staff up to be able to test, to be able to support, to be able to build a sustainment organization, to house the aircraft as we deliver them. So there are a lot of things in that budget beyond our contract value.

And with the dynamics that I described, with EMD moving toward completion over these next handful of years and meeting IOC on the program, with the production meeting its quantity level and then starting to flatten off, and with modernization and sustainment coming online, that whole mix keeps us generally in that high single-digit range, especially as the rest of the portfolio grows as well.

Myles Walton - *Wolfe Research - Analyst*

Okay. Very good. And then the Space booking -- excuse me, Space performance in the quarter, it sounded from your tone that it had improved. Are we now back to positive EACs or are we just less negative EACs that we're seeing?

David Keffer - *Northrop Grumman Corporation - CFO, Corporate VP*

I can take that one. The EACs for Q2 for Space were less negative than the last couple of quarters. Clear improvement there in performance in the business. Still a few small negative items.

But clearly, as you saw from the year-over-year booking -- or margin rate improvement and the overall margin rate that we're now expecting for the full year in Space, there's been demonstrable progress there really related to the actions we've been taking for the last year to improve program performance, deliver cost efficiencies, deliver affordability for customers as we do it. So certainly a good news part of the story there.

Operator

Thank you. Matt Akers, Wells Fargo.

Matt Akers - *Wells Fargo Securities, LLC - Analyst*

Yeah. Hey, good morning. Thanks for the question. Can you comment on the Navy new fighter, the F/A-XX, just what you're hearing on timing there and if you're still planning to bid on that program?

Kathy J. Warden - *Northrop Grumman Corporation - Chair, CEO & President*

Yes. We have not received any updates that would suggest the Navy is changing their approach. They are in competition now for selection to occur next year. And in terms of our overall collection of opportunities, we continue to believe that the Department of Defense will move forward with sixth generation platforms.

The timing is a bit in flux on many of them as they sort out budget priorities. But we are confident that we're well-positioned when and if they do move forward.

Matt Akers - *Wells Fargo Securities, LLC - Analyst*

Great. Thanks. And if I could do a follow-up. I guess Spirit AeroSystems is a supplier on B-21. Any thoughts around the acquisition there with Boeing and if there's a chance you would bring that work kind of in-house?

Kathy J. Warden - *Northrop Grumman Corporation - Chair, CEO & President*

Yeah. I'm not going to comment on specific discussions that we've been having with Spirit. But generally, we acknowledge that they are a key supplier. And we have agreements in place with them that we would expect any owner of the company to adhere to as we move forward.

Operator

Thank you. Pete Skibitski, Alembic Global.

Pete Skibitski - *Alembic Global Advisors - Analyst*

Yeah. Good morning, guys. Kathy, I think it was on the last call, you talked about an increasing amount of Triton export opportunities. I was wondering if you could give us a sense of timing for when those might get signed off on and maybe sized, some of the opportunities?

Kathy J. Warden - *Northrop Grumman Corporation - Chair, CEO & President*

Yeah. So, we are excited that both NATO and Norway have expressed interest in Triton, and we are hopeful that announcements will be coming shortly on both. And as we look to build Triton for the US and Australia, this simply adds to the production line outlook for Triton through the decade.

And so we had envisioned this day coming, where more countries would get the opportunity to see Triton, once it was fielded, has a tremendous ability to surveil large areas of ocean. You can think of the relevance to that in the Pacific, which is what was attractive to Australia and the U.S. Navy. But of course, in the Arctic, this is an area of great importance as well, which is driving the NATO and the Norwegian interest.

Pete Skibitski - *Alembic Global Advisors - Analyst*

Great. Thank you.

Operator

Thank you. Scott Mikus, Melius Research.

Scott Mikus - *Melius Research - Analyst*

It's Scott Mikus on for Rob Spingarn. Kathy, I wanted to ask about the Sentinel program. It had an 81% increase in cost, but the DoD's CAPE office said that their confidence interval on that estimate was only about 50%. So, if the estimates end up being higher or lower, can you talk about opportunities where you think you can lower the cost of the program?

And then as a follow-up, although nuclear modernization is a high priority, budgets aren't unlimited. So how concerned are you that cost growth in Sentinel could result in it being truncated or potentially B-21 end up being a bill payer with the Air Force's budget?

Kathy J. Warden - *Northrop Grumman Corporation - Chair, CEO & President*

Yeah. A couple of things to frame for you in answering those questions. The first is a reminder that the cost growth that is projected is indeed that, a projection over a very long period of time. It covers not just the work that we're doing right now to design, develop, and test, which will largely be through the remainder of this decade.

The majority of those cost growth projections come for the fielding, building out the missile silos for the system, 450 of them. And that doesn't happen really until the next decade. So that's why there's so much uncertainty. It's like any of us sitting here and trying to project what costs might look like 10 to 15 years from now, and that's what's baked into those estimates.

The second part of your question is around the 80% growth. Since so much of that is well into the future, there are still decisions that the Air Force can make today that can drive solutions that reduce that cost projection. And that is what they're doing in the restructuring, looking at those options. And we are partnering with them to do that. And we are committed to help them do that.

And of course, on many of Northrop Grumman's program, we are performing well below the government's independent cost estimates, which is what these are. These are not industry estimates. These are the government's cost estimates. And this is not growth on the current contract; this is projections of future growth.

So with all of that in mind, there is time here to work through a number of factors to determine what the actual cost growth would be and how that gets incorporated into Future Year Defense Programs. But it is not expected to have a significant impact in the next five years, and the Air Force has made that clear.

Scott Mikus - *Melius Research - Analyst*

Thank you.

Kathy J. Warden - *Northrop Grumman Corporation - Chair, CEO & President*

Of course.

Operator

Thank you. Peter Arment, Baird.

Peter Arment - *Robert W. Baird & Co., Inc. - Analyst*

Yeah, thanks. Good morning, Kathy and Dave.

Kathy J. Warden - *Northrop Grumman Corporation - Chair, CEO & President*

Good morning.

Operator

Thanks for all the incremental details on B-21. Super helpful. Just Dave, quickly on working capital, just dynamics going forward here and then how we're thinking about that as it rolls into '25 just given all the growth that you guys are enjoying. Thanks.

David Keffer - *Northrop Grumman Corporation - CFO, Corporate VP*

Sure. Clearly, a really strong Q2 for free cash flow performance, working capital very much an integral part of that. I think it's a good opportunity to take a step back then and look at the rest of this year and beyond and what's factored into our multi-year outlook and our guidance for this year.

And for working capital, the answer is essentially that our expectations are pretty flat; that we're already performing at a very high level, very strong level, for working capital; and that we're not anticipating additional efficiencies, nor are we anticipating erosion to those levels.

So when we talk about a 15%-plus free cash flow CAGR from 2023 to 2026, that is not driven by further working capital efficiencies. It's driven by the expansion of operating profits as we continue to grow the top line and we deliver on margin expansion opportunities.

CapEx is at peak levels this year as it was last. That will decline going forward, both in real dollars and clearly as a percentage of sales toward our longer-term target in the 3% range. And then we should see modestly stronger CAS pension recoveries as we showed in our latest projections earlier this year based on the actuarial environment today.

And then the Section 174 impact on cash taxes will continue to decline each year. So that combination of factors is what leads to the 15%-plus free cash flow growth in our outlook. And working capital is essentially a flat element of that outlook.

Peter Arment - *Robert W. Baird & Co., Inc. - Analyst*

Appreciate the detail. Thanks.

David Keffer - *Northrop Grumman Corporation - CFO, Corporate VP*

You bet.

Todd Ernst - *Northrop Grumman Corporation - VP of Investor Relations*

Josh, we have time for one more question.

Operator

Thank you. David Strauss, Barclays.

David Strauss - *Barclays - Analyst*

Thanks. Appreciate you squeezing me in. And I appreciate all the additional color on B-21, very helpful. Kathy, can you -- you've talked about the company eventually getting back to this 12% margin range. Today, you're at 11%. You talked about B-21 today not really being much of a headwind as we think about margins going forward. Can you talk about that progression back to 12%, how you see that playing out over the next couple of years?

Kathy J. Warden - *Northrop Grumman Corporation - Chair, CEO & President*

Sure. So we've talked about several factors. The first is getting the macroeconomic headwinds behind us related to inflation flowing through our contracts the disruption and challenges that we've had with supply chain deliveries. And those are largely getting behind us, although we do still have some contracts where that is flowing through and we're seeing those impacts, as we talked about in Mission Systems today.

But as those headwinds dissipate, then it really is about the strength of the portfolio shining through in the operating results. And you're starting to see that take hold.

What I would say is that from a cost efficiency standpoint, the team is making sure that the business is sized appropriately in everything from human capital to facilities to our infrastructure. We also are investing in digital enablement, as you know, which is a tailwind to program performance, as we've demonstrated on B-21 with our ability to adhere to modeling that predicts future performance and then hit that performance in the product. That is derisking our programs and driving improved margin opportunity.

And then some more structural items like the mix shift that we spoke about on the call, our cost plus business, which we've had a heavy concentration of here in these last few years, including programs like Sentinel with lower booking rates, which will, over time, move towards fixed price and more profitable programs. And then, of course, international, which is a portfolio tailwind, as more of our business comes from international forces.

So it's that full combination of paths that we are working. We're showing progress on each as we move forward, and it bolsters our confidence that we can drive this business to another 100 basis points of margin performance over the decade.

David Strauss - *Barclays - Analyst*

Thanks. As we sit here today, would you expect margins to tick up next year off of the 11% level?

Kathy J. Warden - *Northrop Grumman Corporation - Chair, CEO & President*

I would.

David Strauss - *Barclays - Analyst*

Thanks. Appreciate it.

Kathy J. Warden - *Northrop Grumman Corporation - Chair, CEO & President*

Thank you. All right. So with that, I'd like to conclude by once again thanking our team for a fantastic quarter. And in particular, I want to recognize Mark Caylor, who is retiring from our company tomorrow after a distinguished Northrop Grumman career and over a decade on our executive leadership team.

And also, I want to note that in the coming months, Dave, Todd, and I look forward to introducing Ken Crews, who is here with us in the room, to our investor community as our incoming CFO effective October 1. So in the meantime, we look forward to talking with you in October and seeing you over the course of the summer. And thanks again for joining our call today.

Operator

Thank you. Ladies and gentlemen, this concludes today's conference call. Thank you for your participation.