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NOC.N - Q3 2023 Northrop Grumman Corp Earnings Call

EVENT DATE/TIME: OCTOBER 26, 2023 / 1:00PM GMT

OVERVIEW:

Company Summary

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to Northrop Grumman's Third Quarter 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 IR*

Thanks, Josh, and good morning, everyone, and welcome to Northrop Grumman's Third Quarter 2023 Conference Call. On the call this morning, we'll refer to a presentation that is posted on our IR website.

Before we start, matters discussed on today's call, including guidance and outlooks for 2023 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. 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. We are all witnessing significant geopolitical tensions across the globe, including the ongoing war in Ukraine and the horrific attacks in Israel. We truly hope that peace and safety can be established for the people in these regions, and we'll continue in our steadfast support for the U.S. and our allies in their pursuit of global security and stability.

On this morning's call, in addition to reviewing our third quarter results and important program events in the quarter, I'll address the U.S. budget and trends we see in the global environment. And as usual, at this time of year, I'll provide our initial outlook for next year.

So starting with the quarter. Our book-to-bill was 1.5x with approximately $15 billion in awards, and our sales increased 9% year-over-year with growth across all four of our business segments. Our backlog now stands at $84 billion. It's a new record, and it strengthens the foundation for our future growth. It also continues to reflect the alignment we have with our customers' priorities and the continued success of our business strategy.

Segment operating income increased by 8% year-over-year, and the OM rate increased over last quarter. Earnings per share were $6.18, up 5% compared to last year. Strong earnings drove nearly $900 million in free cash flow in the quarter, and we remain on track to achieve our 2023 free cash flow target.

Excellent cash generation continues to provide us the flexibility to invest in our capabilities and capacity while returning capital to shareholders. We remain committed to returning over 100% of our free cash flow to investors this year, including $1.5 billion of share repurchases. And year-to-date, we've returned approximately $2 billion to shareholders in dividends and repurchases.

So turning now to the U.S. defense budget. As is common in recent years, the federal government is operating under a continuing resolution to start fiscal year 2024. We're encouraged by bipartisan support for national security priorities and are hopeful an agreement will be reached on full-year appropriations soon. Our guidance and outlook assume a full-year budget is passed by the end of this calendar year or early next year. And as we saw last week, the Administration continues to make supplemental requests for urgent needs, including those in Ukraine and Israel to include investments in weapon systems and defense industrial-based readiness.

The federal government is also developing its budget plans for fiscal year 2025, which we expect to be submitted to Congress early next year. We are working closely with our customers to plan for future capabilities and navigate the fiscal pressures they see to ensure our programs remain well supported.

As we have been discussing throughout the year, we are also seeing an increase in international demand for our capabilities. We've seen a particular increase in our weapon systems portfolio and missile defense technologies like the IBCS product line. One notable example of this growing demand is with AARGM-ER where we've now received interest from more than a dozen countries and just this week, the opportunity for a foreign military sale to Finland was announced.

We are also working with the U.S. Government to provide new advanced weapons capabilities. During the second quarter, we received a $705 million contract from the United States Air Force to develop the Stand-in Attack weapon, also known as SiAW, an air-to-ground weapon with the capability to strike mobile defense targets. Our SiAW offering builds on the capabilities we provide with our high-speed AARGM missile, which is in production.

Building off a mature product baseline, we're able to reduce the developmental time, cost and risk to the SiAW program. These missiles are expected to be the air-to-ground weapon of choice for the F-35 and other fighters.

In our Space business, we remain focused on being at the forefront of technology, and that strategy has enabled us to build a differentiated portfolio that provides end-to-end solutions for our customers, from new space architectures to launch capabilities. We see broad applications for the technologies we've developed with a particular focus on National Security missions. This includes helping to turn the Space Development Agency's vision of a new, low-earth orbit constellation of satellites into reality. In August, we were awarded a $712 million contract to design and build 36 satellites for SDA's Tranche 2 Transport Layer Beta constellation. With this award, along with our work on SDA's Tracking layer and Tranche 1 of the

Transport layer, we are now building nearly 100 satellites for the Proliferated Warfighter Space Architecture. Our successes in this area highlight our ability to compete and win in highly competitive and dynamic new markets within the Space domain.

In addition, we had two notable launch events in the quarter. We successfully launched our 19th resupply mission to the International Space Station as we continue to execute under NASA's commercial resupply contract. And five of our GEM63 solid rocket boosters helped to power ULA's Atlas V launch of a national security payload. These rocket motors will continue to support future ULA launches, to include ULA's Vulcan rocket.

For Next Generation Interceptor, we successfully manufactured the first set of solid rocket motor cases in August, and we're on track for our preliminary design review in the fourth quarter, more than a year earlier than the original contract date. These are just a few examples of the focus we have on strong program performance across the portfolio.

Now before I turn the call over to Dave to provide more details on the quarter, I'd like to provide some initial color on our 2024 outlook. We continue to see solid growth across all four of our businesses, with sales growth of approximately 4% to 5% compared to our latest 2023 guidance, which we've now raised by $800 million throughout the year. We also expect operating income to grow by 4% to 5% year-over-year. We reaffirm our free cash flow outlook range of $2.25 billion to $2.65 billion in 2024, which accounts for continued investment in the capabilities and capacity needed to grow our business and support our customers.

So in summary, Northrop Grumman is well positioned to drive value creation for our customers and our shareholders. We are focused on executing our strategy, driving operating performance and generating cash for our disciplined capital deployment.

So now with that, I'll turn it over to Dave to provide some more details on the segment results, 2023 guidance and our outlook.

David F. Keffer - *Northrop Grumman Corporation - Corporate VP & CFO*

Thanks, Kathy, and good morning, everyone. As Kathy described, we generated another strong quarter of results. The business is well-positioned in growing segments of the market, and we're delivering key capabilities that address our customers' missions. As macroeconomic conditions improve, and pension and tax cash flow headwinds reverse over the next few years, we have a great opportunity to create value for shareholders through substantial cash flow growth, consistent with our long-term strategy. Taking a look at our demand metrics, we ended the third quarter with a record backlog of $84 billion, bolstered by several new competitive awards. And as a result, we now expect our full-year book-to-bill ratio to be well over 1x.

Turning to the top line. We continue to build on our momentum from the first half of the year, with overall sales growth of 9% in the third quarter. This includes growth in all four of our segments for the second straight quarter as our teams continue to ramp up new wins, add new talent and manage through continued pressures in the supply chain.

At the segment level, Aeronautics posted sales growth of 9%, driven by higher volume on Manned Aircraft programs. DS grew by 6% on continued strength in their missile defense and armaments portfolios, including IBCS, GMLRS and HACM. Mission Systems continued to generate rapid growth of restricted sales in the Networked Information Solutions business, driving their top line up 7%. And Space again delivered double-digit sales growth as a result of the continued ramp on programs like GBSD, NGI, OPIR and several in the restricted domain.

Moving to segment margins. We're pleased with these bottom-line results in a dynamic environment. In total, segment operating income grew by 8% compared to the third quarter of last year. As we expected, we delivered an incremental improvement in our segment OM rate from earlier quarters this year, expanding to 11.1% in Q3. Program performance remained strong across the portfolio.

Our Aeronautics and Defense businesses generated a healthy volume of favorable EAC adjustments through efficient execution and risk retirements. MS margins were down slightly as mix shifted to more cost-type development efforts, particularly in their restricted portfolio. And at Space, given the rapid backlog growth we've experienced, strong execution and program performance are our top priorities. Space margins improved by 80 basis points this quarter compared to Q2. Diluted EPS in the third quarter were $6.18, up 5% from the prior year. The increase was driven by higher sales and segment performance, along with a lower share count. We also recognized a gain from the sale of an Australian minority investment in

Q3 that we described on prior calls and included in our guidance. Partially offsetting these items was lower net pension income of roughly $1 per share, a non-operational impact consistent with the first two quarters.

Q3 was a strong period for cash generation with free cash flow of nearly $900 million. On a year-to-date basis, this brings us to nearly $500 million of free cash flow, well ahead of where we were at this time last year. We continue to remain disciplined in managing our working capital, and we saw improvements in these accounts across the company in Q3.

With respect to cash taxes, the IRS recently provided additional guidance on the amortization of research and development expenditures under Section 174 of the tax code. This guidance did not change our interpretation of the provision. But upon finalizing our 2022 tax returns, we lowered our estimates for Section 174 cash taxes based on applicable R&D costs that were below our original estimates. Offsetting the lower 174 taxes is an increase in other tax items, the net result of which is a multi-year cash tax forecast that is roughly unchanged.

Moving to 2023 guidance. I'll begin with a few updates to our segment estimates as shown on Slide 7 in our earnings deck. First, based on the strength of our year-to-date results, we now expect modestly higher sales in our Aeronautics business in the mid to high $10 billion range. This represents a return to growth this year at AS, a year earlier than expected, and continues to assume that we will be awarded the first LRIP lot on the B-21 program in the fourth quarter after first flight.

As the Air Force said in September at the AFA Conference, we are progressing through ground testing, and we're on track to enter flight testing this year in line with the program baseline schedule. And we are again increasing our top line expectations for our Space segment based on new wins and continued strength in this business. We now expect 2023 sales of approximately $14 billion, which represents year-over-year sales growth of 14%.

For operating margin rate, we're projecting a slightly lower operating margin rate at MS to reflect their year-to-date trend line. Other segments are unchanged. At the enterprise level, we're increasing our sales guidance by another $400 million and now expect 2023 sales of approximately $39 billion. This represents year-over-year growth of roughly 6.5%. We are maintaining our guidance for segment operating income. Year-to-date trends would indicate a figure towards the lower half of that range, and we're reaffirming our estimates for EPS and free cash flow.

Next, I'll build on Kathy's comments on our 2024 outlook. Sales growth has accelerated sooner than we expected in 2023, and we continue to project growth at all four of our business segments next year. We expect segment margins in the low 11% range, and we continue to project improvement over time as we see benefits from the stabilizing macro environment, our cost efficiency initiatives, and our business mix improvements. We continue to anticipate CapEx to be roughly consistent as a percentage of sales in 2024 before declining in 2025 and beyond. And shareholder returns will remain a top priority for our free cash flow deployment, including returning at least 100% of free cash flow to shareholders next year.

Given the volatility in the financial markets, I'd also like to provide a quick update on our pension plans. Our funded status is now above 100% as of the end of Q3. And we continue to expect minimal required cash contributions over the next several years. This is a discriminator for us that supports our affordability and competitiveness as well as our capital deployment optionality. Given that our GAAP earnings per share are affected by net pension income, as we did last year, we have provided a pension income sensitivity table for 2024 on Slide 9. Our forecast in early 2023 was predicated on asset returns of 7.5% and a discount rate of roughly 5.5%.

Through September 30, financial market movements have led to a roughly 50 basis point increase in discount rates and a year-to-date asset return of 1% to 2%. This combination of results would reduce net FAS pension income and increase CAS recoveries from our prior projections. Based on the sensitivities highlighted on the slide, the net result would be an impact to 2024 GAAP EPS of roughly $0.50 compared to our initial outlook provided in January. Keep in mind that FAS pension income is non-cash in nature. Higher CAS estimates would provide a modest benefit to our cash flows but could have a modest downward impact on EACs in the quarter in which they are updated, consistent with this year's pattern.

Speaking of cash flow, we continue to see a path to grow our cash flows at a greater than 20% CAGR next year and through 2025 with further expansion in the following years. As is our practice, we'll provide our latest multi-year outlook for free cash flows on the January earnings call. We remain confident in the long-term value creation opportunity from free cash flow expansion and disciplined capital deployment through the rest of the decade.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Douglas Harned with Bernstein.

Douglas Stuart Harned - *Sanford C. Bernstein & Co., LLC., Research Division - SVP and Senior Analyst*

In Aeronautics, you're raising your top line guidance. Dave, you talked about this. I mean, Kathy, we've talked about this subject many times, with the valley that you had kind of forecast for revenues this year as legacy programs declined. But things are getting better. So what are the puts and takes here that appear to be starting you on a growth path going forward? And given the mix, do you still see Aeronautics as able to maintain 10% margins in the coming years?

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

Thanks, Doug. So the puts and takes that we've been talking about have materialized as we expected. The biggest factor was the programs that were declining are largely through our year-over-year compares now. Those include Global Hawk, which is in sustainment; Triton, which is still in production. But as we look forward, that rate is fairly stable and so it is not contributing to significant growth. What is contributing to growth is B-21, and we expected that ramp to start this year and continue and we still anticipate that. And then other stabilizing factors are the F-35, the E-2D large programs that have generally remained constant.

As we look forward, we see that same profile in those program categories, and that will contribute to growth at AS. We do expect that margin rates will be near that 10% mark that we've been talking about. And we've gone through, again, those major categories of the portfolio and how they contribute. Our mature production is about 60% of the portfolio and that tends to have above 10% margins, whereas the B-21 has contributed lower margins and will, as we move into production, contribute zero on the production. That's our planning assumption, of course. And so it's the mix of that entire portfolio that brings us to that approximately 10% expectation for the near to midterm.

Douglas Stuart Harned - *Sanford C. Bernstein & Co., LLC., Research Division - SVP and Senior Analyst*

And then when you look forward into 2024, I know in the guidance today, you said 4% to 5% increase in sales, 4% to 5% increase in operating income. I mean that implies really no margin expansion overall in 2024. Can you talk about that and just how you're thinking about margin progression going forward?

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

Absolutely. So at this point in the year, as is normal, we wanted to provide an outlook. They are broad ranges. So the 4% to 5% both for sales and operating margin, it gives us an opportunity to do further planning and characterizing of the budget as that becomes more clear, and we'll provide more precise guidance in January.

What I would say is that we are still on track for the trends that we have spoken of in operating margin. We see improvements, and that is reflected in our guidance for 2023 in the fourth quarter, again, sequential improvement over Q3 performance. And we expect as we move into next year, there are continued opportunities for improvement in operating margins. They are related to macroeconomic trends, largely inflation, labor cost, productivity. And so we'd like to get a little bit more time under our belt before we get concrete about what that improvement might look like. So we are expecting some modest margin rate improvement into next year as we have outlined for Q4 of this year.

I also just want to point to the fact that the free cash flow growth is the real point for our investors to understand, while earnings growth will be there, we also have headwinds that have historically in the last couple of years, challenged us on free cash flow that are dissipating. We've talked about -- and I'm sure we'll talk more on today's call about Section 174, which is a decreasing headwind over time. We also see the pension headwind curtailing. And then, of course, as we reduce our CapEx spend starting in 2025, even more robust free cash flow growth. But looking at 20% year-over-year free cash flow growth is really an important milestone for us, and something we're very focused on delivering.

Operator

Our next question comes from Ronald Epstein with Bank of America.

Ronald Jay Epstein - *BofA Securities, Research Division - MD in Equity Research & Industry Analyst*

Yes. Across the industry, there's been a lot of discussion about supply chain capacity constraints, labor constraints. One thing that's popped up in a lot of discussions is just the availability of solid rocket motors for missiles and so on and so forth. Just broadly, Kathy, how is Northrop handling? You're getting a surge in demand at a time where kind of post-COVID and all that, I mean, labor has been tough and supply chains are tough. I mean how is it going? And what's Northrop doing to handle that?

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

Ron, we got ahead of seeing the demand, not quite to the degree that the demand has increased in the last 18 months, but we had forecasted an increase in demand, particularly in our solid rocket motor business, but broadly as we've been ramping up for production of satellites, aircraft and Mission Systems capability across the board. It's why our CapEx has been elevated. And so first and foremost, we did what's necessary, and that is invest in our workforce and our facilities to be able to support that demand. And it's what's allowing us to support both our direct customers and primes who are now coming to us asking for that capability. We are going to continue to do that, and that's why we still have some robust CapEx plans in place for 2024 reflected in the outlook we provided.

We are seeing labor back to pre-pandemic levels in terms of our ability to hire, retain. Certainly, inflation is causing more labor rate escalation than we saw pre-pandemic, but we are able to get the workers that we need. Our focus now is on productivity. And there too, we've invested in training. We've invested in standard work instructions, in digital technology, all of which are enabling productivity in our workforce. That has been a little slower to materialize with our supply chain. And so we are spending a lot of Northrop Grumman resources with our suppliers, co-locating with them, and helping them to improve productivity as well. And once we remove that bottleneck, I think we'll, as an industry, be able to no longer have capacity be our constraining factor.

But with that said, and now we're looking at a supplemental and growing international demand, all of which continue to add to the demand equation. So we are still going to be a bit in a catch-up mode because it does take generally 18 to 24 months to lay in new capacity to support that demand.

Ronald Jay Epstein - *BofA Securities, Research Division - MD in Equity Research & Industry Analyst*

Got it. Got it. And then maybe a follow-on for Dave. Is there -- can you give us any update on how you're thinking about the B-21 LRIP? Because that's something that's kind of always on everybody's mind.

David F. Keffer - *Northrop Grumman Corporation - Corporate VP & CFO*

Sure. It's Dave. So we continue to anticipate, as we noted in the earlier part of the call that the first LRIP contract will be awarded in the fourth quarter. That's consistent with our expectations that we've described throughout the year and reliant upon first flight occurring between now and that LRIP contract award. And we continue to evaluate our performance and our outlook on the LRIP phase of the program each quarter and did not make any significant changes to our estimates for that phase during the third quarter. So we'll continue to update everyone over time as we have updates.

Operator

Our next question comes from Sheila Kahyaoglu with Jefferies.

Sheila Karin Kahyaoglu - *Jefferies LLC, Research Division - Equity Analyst*

Kathy, you highlighted a few moments ago that free cash flow growth is the real story here. So I want to focus on that since you mentioned it. Can you talk about multi-year free cash flow growth? You've done so in the past. But how do you think about the biggest drivers from a top line networking -- net income drop-through, tax, CapEx perspective?

David F. Keffer - *Northrop Grumman Corporation - Corporate VP & CFO*

Sheila, it's Dave. I'm happy to provide some additional color there. The 2024 updates that we provided on the call today should give you a sense for our near-term sales and earnings growth expectations underlying that free cash flow expansion. We do expect to continue to see a leading sales profile in the growth of our business. And as we've talked about, we anticipate long-term margin expansion opportunity as well. And so both of those are foundational to our multiyear free cash flow growth expectations.

On top of that, we've talked about the last couple of years that 2023 and 2024 would be a period of peak capital intensity for the business, and that is consistent with our current expectation. Large programs that we've had for a number of years as well as new wins we've had that have grown our backlog so significantly over the past couple of years have all contributed to a peak period of capital intensity right now that we have clarity on sources of decline in the middle of the decade. And so we expect that capital intensity to be alleviating in 2025 and beyond.

Working capital performance is really among the best in class at this point. And even with a modest headwind from the progress pay changes, we anticipate continuing to be able to deliver stable working capital performance, not a meaningful driver of headwind or tailwinds there.

And then you get to the two items Kathy mentioned earlier, modestly higher CAS pension recoveries currently projected over the next few years. Of course, those will continue to fluctuate based on -- primarily on asset returns, but other actuarial changes that are possible as well.

And then on the cash tax side, as we've noted, a pretty stable outlook for free -- for cash taxes from what we've been anticipating previously, and that outlook is for declining cash taxes over the next several years largely driven by the Section 174 movement as we get through the period of amortization over these five years. So all in all, a number of key tailwinds most critical of which, of course, is the expectation of continued growth and margin opportunity in the business.

Operator

Our next question comes from Myles Walton with Wolfe Research.

Myles Alexander Walton - *Wolfe Research, LLC - MD & Senior Analyst*

Kathy, could you comment a bit on relative growth rates at a minimum for the segments next year? And just playing off the Space backlog, which continues to expand pretty wildly, maybe just dig in a little bit deeper as to how the complexion of that backlog might play out on hopefully a margin expansion profile from here?

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

Yes, Myles. So as we have been saying all year long, we expect space growth to moderate as we go into next year, still be our fastest-growing segment, but the growth profile across the four businesses will be more similar next year, more tightly clustered, if you will, around that growth rate we're projecting for the enterprise at 4% to 5%. DS and MS will likely be around that profile in the mid-single-digit range, although I will say DS this year is experiencing some upward pressure on growth due to the demand that we spoke about, particularly globally for air and missile defense and weapon systems.

If that continues, that would continue to push DS's growth expectations even higher into 2024. And then AS will still be in growth territory, but as we've talked about, it will be modest growth into 2024. So that gives you a sense of the relative order that we see. And for Space, in particular, while we have approximately doubled that business in the last five years, so it's been just on a tremendous growth tear. We are very focused now on the performance of that backlog and ensuring that we can, as you said, deliver the margin expansion, and that is still very much our pathway in 2024.

Myles Alexander Walton - *Wolfe Research, LLC - MD & Senior Analyst*

And can you just clarify on the underlying margins, EACs were still negative within Space. Is there -- and we've seen that for now five quarters. Are there specific programs you could point to, to say, okay, these are running off and that's why we're going to have this margin expansion profile?

David F. Keffer - *Northrop Grumman Corporation - Corporate VP & CFO*

Myles, this is Dave. On that one, there has not been any one or two particular programs driving the majority of the negative EAC adjustments you're referring to over the last year plus. It's broader. And to Kathy's earlier point, there has been so much backlog expansion that there are so many new programs in our Space business over these last few years, examples of really strong market share gains. And it's been across a number of those programs that we've seen EAC pressure, given the newness of those development programs. And so I wouldn't characterize them as falling off anytime soon.

If anything, we see opportunities for a number of programs in our Space business to transition to more mature phases of those programs, including production phases over the next couple of years, which is important to the broader margin expansion opportunity point that Kathy described. So I think what we see here is an opportunity for margin growth as we see the continued stabilization of the macro factors that have really been underlying industry-wide pressures over the past couple of years and the continued maturity of those programs over those same couple of years coming up.

Operator

Our next question comes from Kristine Liwag with Morgan Stanley.

Kristine Liwag - *Morgan Stanley, Research Division - Executive Director, Head of Aerospace & Defense Equity Research and Equity Analyst*

Kathy, on the Stand-in Attack Weapon win, some of your competitors indicated that the risk/reward profile wasn't as strong on this particular program. Can you provide more color on your competitive edge and how this pursuit jives with the risk tolerance you've demonstrated elsewhere, like on the decision not to bid on NGAD as a prime?

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

Yes. Thank you. So in my comments, I alluded to the fact that AARGM is a product line that we have. We've talked about the base AARGM product, the AARGM-ER, or extended range, and now the SiAW award and with each of those products they are building off of a mature technical baseline.

As I've talked about our approach thinking about fixed price, I have often said fixed price is appropriate where it's either a commercial item or an item that has reached a design maturity and been risk reduced to where we know what it will take to deliver that product. Because of the maturity of AARGM and us having a product line that met the Air Force requirements for SiAW to bring forward, we are able to reduce cost schedule and, of course, have better risk management. That allows us to have the risk tolerance then to bid fixed price.

And I recognize that in competition, there are many factors, but when a company has invested and gotten the mature product line, there is a natural advantage that comes with that. And that's the situation we found ourselves in with SiAW in that specific competition.

Kristine Liwag - *Morgan Stanley, Research Division - Executive Director, Head of Aerospace & Defense Equity Research and Equity Analyst*

I had a follow-up question on the B-21. Does the current budget standoff in D.C. impact flight testing or the timing of the LRIP award?

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

No, it does not. As we look at the timing of the LRIP award, as Dave said, we still expect that to happen this year. And as we have talked about before, first flight is a milestone that the Air Force is looking to achieve before they make that award, and we are on track still anticipating first flight this year.

Operator

Our next question comes from Robert Stallard with Vertical.

Robert Alan Stallard - *Vertical Research Partners, LLC - Partner*

Kathy, I just wanted to follow up on your budget commentary at the start of the call. I'm wondering if you're putting any contingency plans in place in case we get arbitrary DoD budget cuts as a result of this craziness in Congress.

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

So Rob, we have looked -- it would be irresponsible of us not to run some numbers and look at where we might have risk. And as I mentioned in my commentary, we are working with our customers to navigate any budget challenges that they see, either as a result of not getting appropriations passed in a timely fashion in accordance with the Fiscal Responsibility Act requirements or even as they look into 2025 and the pressures that they have there with a minimal top line growth rate. But we are not seeing any significant risks to our portfolio at this time, but we will continue to monitor that as budget discussions progress. We're just very pleased to see that the House has a Speaker and we should expect to begin to see those bills moving through Congress now.

Robert Alan Stallard - *Vertical Research Partners, LLC - Partner*

Yes. And then as a follow-up, you mentioned the strong demand on the defense export market at the moment. I was wondering if there could be any capital deployment opportunities there, either Northrop Grumman acquiring companies overseas or making other investments.

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

We are already making capital investments that support that growing demand in missile defense and armaments. And so as we have talked about our CapEx investments over the last several years and planning forward into 2024, those do support our international product lines. We are not seeing a significant increase that we would anticipate in that demand signal yet. We are monitoring it both through the supplemental, but we've already baked in a good bit of product line growth that we've accounted for in our CapEx planning over the next several years. And so at this point in time, I don't see that providing more upward pressure on CapEx.

Operator

Our next question comes from Cai von Rumohr with TD Cowen.

Cai von Rumohr - *TD Cowen, Research Division - MD & Senior Research Analyst*

Yes. So to go back to Doug's question, I mean, you're looking for basically flat margins next year. And kind of in recent quarters, Kathy, you've made the point about the opportunity for Space margins to go up. Certainly, if I look at Defense, basically with more munitions moving up, I think you've made the point that there should be some opportunity there. You've brought the target down for MS this year, which would suggest an easier base of comparison for next year. I think you've talked about Aero as being roughly flat.

But as you look at your portfolio, is there opportunity for those margins to move up next year? And if so, which are the sectors that have the greatest opportunity for margin improvement and which are the ones that perhaps face greatest risk that margins would be flat to down?

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

Yes. I like the way you're thinking. It's exactly the challenge that me and the team are discussing amongst ourselves is to how we do drive margin improvements next year. And in the Q2 call, I laid out for our investors what that path is and the key factors associated with improvement. And let me just touch on each of those and then I can tie it also to where the segments see the greatest opportunity. For macroeconomic factors, I've talked about those already on the call. We are seeing inflation be a bit stickier than we had hoped at this point in time. We are incorporating that into our forward estimates, but it is impacting our ability to return to higher levels of profitability faster.

Productivity is another area where we are working to improve productivity, not just within our company, but our supply chain. That is opportunity. That would be upside to a flattish look next year. Although, as I also indicated, we are expecting some modest improvement in margin rate next year. What then we look at is the mix, and that has been a factor for both Space and Mission Systems over the last couple of years, particularly notable for Mission Systems this year. We don't see a significant mix shift going into next year. It is a very gradual mix shift. And so that -- those two pieces of the business will still feel some margin rate pressure until they can shift to more production in the portfolio.

As you note, our Defense Systems business has the most both top line and margin upside that could come as the result of growing international demand as well as what we see domestically, particularly through the supplemental. Those are uncertain at the moment, so we do factor those in our plan, but that could be a source of upside. But then, of course, we are managing risks across the entire portfolio. And so when we put all of that together, we're looking at some modest rate improvement into next year and really striving to do better. But at this point in the year, we are very comfortable with what we've laid out as a set of expectations.

Operator

Our next question comes from Ken Herbert with RBC Capital Markets.

Kenneth George Herbert - *RBC Capital Markets, Research Division - Analyst*

Kathy, maybe I just wanted to follow up on the strong bookings this year. Can you call out or maybe help quantify how much of that could have been or is international? And as we think about sort of this growing set of international opportunities, maybe not so much in '24, but how much international growth could you see next year and into '25? And I guess, more importantly, how could that impact margins as I think about maybe international being slightly accretive to margins?

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

Yes, Ken. So you're pulling on all the right threads. Our bookings are up for the international portfolio this year. And as we look into our future plans, we expect that, that trend will continue. It takes a little while to then materialize that into sales in a meaningful way. So we see a gradual shift in terms of the percentage of our overall sales that will come from international.

We've talked about achieving a double-digit growth rate. I would expect that not necessarily in 2024, but into 2025 because of the time it takes to ramp sales on these awards. And so you could also expect that any upward margin opportunity would also be more material starting in that 2025 time frame than 2024, but we are actively working those opportunities now so that they do materialize in that time frame.

Kenneth George Herbert - *RBC Capital Markets, Research Division - Analyst*

That's helpful. And is there any way to think about just with, obviously, a lot of what we hear in the geopolitical environment, are you seeing that yet translate into sort of bid opportunities when you think of international? I'm just trying to get a sense as to with all of the -- all of sort of this growing expectation, how much you're actually seeing that yet transpire or actually materialize in terms of real opportunity you're going after?

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

We are seeing it in signals of demand. So I mentioned on our last call that we have over ten countries that have expressed interest in our IBCS product line. Today, I noted another dozen or so that have expressed interest in AARGM. As we look forward, we do expect that, that demand signal for many of those countries will translate into contracts but it takes time. And that's why I was talking about seeing 2024 as a time frame where we'll be working to translate those demand signals into contracts, but 2025 being more the time frame we expect them to materialize. And I'd say the same is true with the domestic marketplace as we look to replenish U.S. stockpiles or to work through the supplemental budget that I would expect to be more material for us in 2025, but we're working now to ensure that we're qualified to be a supplier on either second source or new missile programs.

Operator

Our next question comes from Scott Deuschle with Deutsche Bank.

Scott Deuschle - *Deutsche Bank AG, Research Division - Research Analyst*

Kathy, in the emergency supplemental request from the White House, there was $2.6 billion included for classified Air Force procurement programs. Do you have any sense for whether that could potentially help support your programs in the event that there's an extended CR here? Or is that just entirely a black box as we might otherwise expect?

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

Yes, there's really nothing I can comment on with regard to that, Scott. I will simply say we do continue to work with the Air Force on ensuring that we have the resources necessary to make the B-21 program successful.

Scott Deuschle - *Deutsche Bank AG, Research Division - Research Analyst*

Okay. Fair enough. And then Dave, the updated margin guide on MS implies something like a 15.9% margin in the fourth quarter. Just curious if you could talk a little bit about the drivers there. Obviously, you've done above 16% before so I assume something like what we've seen historically. But just curious for any commentary on drivers.

David F. Keffer - *Northrop Grumman Corporation - Corporate VP & CFO*

Sure. A couple of thoughts there. One, you saw a similar trend last year in our MS business with its strongest margin performance in the fourth quarter of the year, driven by the mix of business that we tend to see spike in the fourth quarter with more predominance of mature fixed price programs in that fourth quarter sales mix. We anticipate a similar trend this year.

With that said, we need to continue to perform and execute well and with efficiency across that MS portfolio to deliver on that result. In aggregate, the 2023 margin guidance change for MS is really driven by mix. A lot of the growth in MS this year has been in critical work in the restricted portfolio that tends to be, at this phase in its life cycle, cost-type work. There is opportunity for that work to shift back towards more fixed price over time. But the fact that most of the growth in MS this year has been driven by growth in cost-type contracts has been a pressure on its margin rate. With that said, it along with the rest of our businesses drove margin dollar growth year-over-year in Q3, and we anticipate the same trend in Q4.

Operator

Our next question comes from Gavin Parsons with UBS.

Gavin Eric Parsons - *UBS Investment Bank, Research Division - Analyst*

Dave, I was hoping you could go into just a little bit more detail on the Section 174 change and what the offset is given it would seem like that has to be pretty sizable, especially if you get some recapture from 2022?

David F. Keffer - *Northrop Grumman Corporation - Corporate VP & CFO*

Sure. Happy to go into that. I think the important takeaway here is that our cash tax forecast is, in the aggregate, largely unchanged, in that it remains a tailwind for our free cash flow outlook over these next several years. To your point, 174-driven taxes have come down a bit in that outlook. That's largely due to lower-than-projected cost applicable to the 174 guidelines, not a change in our interpretation of the latest guidelines. To be clear there, we will continue to assess any future guidance that comes out on 174 and continue to apply our best interpretation of that guidance to our own costs and the appropriate and applicable cost there. With that said, the issue that others in the industry have discussed around the difference between cost type and fixed price R&D-related expenditures is less impactful for us than it appears to be for some of our peers, particularly given the reduction in our 2022 174-driven costs. So less of an impact based on our interpretation than for others.

So with all of that said, there are some puts and takes across a business of our scale with as many open tax years as we have, and we disclose all this in some clarity in our 10-Qs every quarter. There is a balance of upside and downside items that are largely driving an unchanged cash tax forecast.

Gavin Eric Parsons - *UBS Investment Bank, Research Division - Analyst*

Got it. That's helpful. Kathy, you mentioned stickier inflation. Any update on discussions with customers for relief on that front?

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

Discussions continue, and I think we're making good progress in having awareness of the issue. And with Congress setting a precedent last year of having some funds available, I'm hopeful that once again this year, we will see funds appropriated that give the departments the flexibility, both in language and dollars to address these issues.

Operator

Our next question comes from Seth Seifman with JPMorgan.

Seth Michael Seifman - *JPMorgan Chase & Co, Research Division - Senior Equity Research Analyst*

Apologies to be deep in the weeds on the taxes, but kind of what I got left here now. And so I just wanted to ask you, Dave, just to understand that a little better and your interpretation of this. If I look at what Lockheed paid in 174 payments last year, it was like 38%, 39% of their IRAD and you guys paid like 75% of your IRAD. So it would seem like that's a very different interpretation. And it would seem like there -- the guidance is consistent with the idea that IRAD is kind of the basis of what's subject to Section 174. And so maybe if you can provide -- I know we spoke about this, but just a little bit more color on what's different about your business.

David F. Keffer - *Northrop Grumman Corporation - Corporate VP & CFO*

So I appreciate the question, Seth. I know it's been a common line of discussion for us, and it's an interesting topic. I would say this probably isn't the time or the place for us to assess differences in our own interpretation of guidance from peers. We're not familiar with the interpretations of our peers. When it comes to our own view of Section 174, it is broader than IRAD and includes a portion of our contract-driven R&D as well. With that said, as I mentioned, we'll continue to assess potential future guidance, even following on and clarifying guidance provided in September. And we're open to different interpretations based on different guidance we may get in the future.

But importantly, as I mentioned, a difference in contract type interpretation is not nearly as impactful for us as others have said it is for them. And so I think, in aggregate, this should be less of a focus. That interpretation difference should be less of a focus for the Street going forward than it has been for us in the recent past. And the important point to take away is that our cash tax forecast hasn't changed in any meaningful way and remains a tailwind for us. It's a small piece of the much more important puzzle that is really strong free cash flow growth opportunity for us over these next five years, leading to a lot of optionality as it relates to capital deployment. And I think that's the more important headline.

Operator

And our final question comes from David Strauss with Barclays.

David Egon Strauss - *Barclays Bank PLC, Research Division - Research Analyst*

Wanted to ask specifically on B-21 and your guidance for -- it sounds like 10% margins at AS next year. Are you assuming, Kathy, any incremental inflation relief on B-21 in that?

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

So we look at the EAC, and it has a number of factors incorporated into it our expectations for performance, our expectations for the contract terms. And so all of that is factored into then what goes into the expectations that I laid out for B-21. And as we've consistently said through the year, we are planning at a zero profitability. But we have to perform and we are working hard to ensure that, that plan is what we achieve.

David Egon Strauss - *Barclays Bank PLC, Research Division - Research Analyst*

Okay. And apologies, Dave, I got to go back to Section 174. Just to level set us, are you -- in your free cash flow forecast this year, are you still assuming $700 million impact from Section 174 and stepping down roughly 20% from there next year?

David F. Keffer - *Northrop Grumman Corporation - Corporate VP & CFO*

No, I appreciate the clarifying question. We have stepped down about 20% below our prior estimates for the impacts of the annual effect of Section 174, and we've detailed that further in our 10-Q in terms of the impacts on 2022, 2023 and beyond based on the numbers that we've calculated with the benefit of actual cost to apply as we have formulated our 2022 tax return. So it's a bit lower than that. As I mentioned, that's offset by a couple of factors moving in the other direction, which in aggregate, leads to no change in our cash tax forecast for this year or the next couple of years. So no change to that element of the free cash flow guidance.

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

Thanks, David. So quickly before concluding the call, I just want to take a moment to acknowledge our team and thank them for their contributions to our company and our customers. And in particular, I want to thank our General Counsel Sheila Cheston, who is retiring after 13 years with the company. Sheila has been instrumental in instilling a culture of strong ethics and she has provided outstanding counsel for the company and been a trusted partner to the Board and to me and the leadership team.

Kathy Simpson is our new General Counsel. She is also a valued member of our team. She's been with us for many years, and she brings a wealth of broad-based legal and strategic expertise to the role. So we're thrilled to have her.

And I also want to congratulate Rob Fleming, our new Space Systems Sector President and thank Tom Wilson for his leadership in guiding the space business for the last several years during a period of just tremendous growth. Tom is now taking a new role with the company; he's going to help us expand our business development capabilities across the entire enterprise. And Rob has extensive experience running complex businesses during his 18 years with our company. He most notably and recently led the Strategic Space Systems Division, which is the largest segment of our Space Sector, and I think what you see from our team is that the depth and strength of our team allows us to make these internal transitions very smoothly. I'm looking forward to working them and them meeting you in future years.

So thank you for joining the call today, and we look forward to speaking with you again on our fourth quarter call in January.

Operator

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