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NOC.N - Q4 2022 Northrop Grumman Corp Earnings Call

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OVERVIEW:

Co. reported 2022 sales of $36.6b and transaction-adjusted EPS of $25.54. Expects 2023 sales to be $38.0-38.4b and EPS to be $21.85-22.45.

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to Northrop Grumman's Fourth Quarter and Year-End 2022 Conference Call. Today's call is being recorded. My name is Norma, and I'll be your operator today. (Operator Instructions). I would now like to turn the conference over to your host today, Mr. Todd Ernst, Treasurer and Vice President, Investor Relations. Mr. Ernst, please proceed.

Todd Ernst - *Northrop Grumman Corporation - Corporate VP and Treasurer & VP of IR*

Thanks, Norma. Good morning, and welcome to Northrop Grumman's Fourth Quarter 2022 Conference Call. We refer to a PowerPoint presentation that is posted on our IR web page this morning. Before we start, matters discussed on today's call, including guidance and outlook 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 includes non-GAAP financial measures that are reconciled to our GAAP results in our earnings release. On today's call 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, and thank you for joining us. The Northrop Grumman team delivered another year of strong performance in 2022, positioning our company for the coming year and beyond. A growing global demand environment and the team's success in capitalizing on competitive opportunities drove exceptional bookings.

Top line growth accelerated throughout the year, driven in part by improving labor trends. I'll note that we set our sales and EPS guidance ranges at the beginning of 2022, and even in a dynamic macro-environment, we navigated the challenges to deliver at or above the high end of those ranges, and importantly, to deliver capability for our customers.

This performance highlights our solid operating execution, our ability to win new business and the alignment of Northrop Grumman's portfolio to our customers' priorities. We enter 2023 with a backlog of more than 2x our annual sales. This strong backlog, along with increasing demand and rising global defense budgets supports our expectations for continued growth.

Given this and supported by robust headcount growth, we have increased our 2023 sales guidance range from our October outlook. We are projecting solid segment margin performance that takes into consideration inflationary pressures and supply chain disruptions, consistent with the expectations we outlined on the October call. And we expect a greater than 20% compound annual growth in our multiyear cash flow outlook that supports continued investments in the business and significant returns of capital to shareholders.

Before providing more details on our outlook, I'm going to highlight a few notable achievements from the previous year that underscore the tenets of our long-term strategy and illustrate our positioning for the future. In 2022, the James Webb Space Telescope proved its status as the world's most powerful space telescope and an engineering marvel. It achieved full operational status, shared first images in July and continues to discover and inspire with its incredible insights into distant galaxies. This project is just one example of the technology innovation and leadership our team brings to our customers. And it has provided an excellent platform for attracting talent to our industry and our company.

In 2022, we continued to win new competitive awards across the company, achieving a book-to-bill ratio of 1.07x. Two notable new awards are the Space Development Agency's Tracking and Transport layers. As our customers look to expand their resilient national security space capabilities, these programs leverage our advanced space solutions for low Earth orbit and showcase our ability to compete and win programs across a range of missions. We also completed over 40 successful launch and space missions in the year, exemplifying our end-to-end capabilities in the space market and our ability to perform at scale.

Further, our solid rocket boosters helped propel NASA's Space Launch System as part of the Artemis 1 mission with the largest human-rated solid rocket boosters ever built. We also received a $2 billion award for GEM 63 solid rocket boosters in support of Amazon's Project Kuiper. Together, SLS and Kuiper validate the robust investments that we've made in solid rocket motor capabilities.

We also delivered advanced architectures that integrate sensors to provide unprecedented situational awareness for our customers. One example is our IBCS solution. After successful testing in the fourth quarter, IBCS is poised to transition from LRIP to full-rate production in 2023. IBCS integrates systems that weren't designed to work together, creating a seamless air and missile defense network and allowing customers to better utilize their defense assets. This capability is needed more than ever to address advanced threats and it's one where we've seen a significant increase in interest across our global customer base with 10 additional countries expressing interest in obtaining this system.

We continue to keep our focus on innovating and leveraging our strong position in advanced technology. This includes the development of a new radar for the F-35. This radar is capable of defeating current and projected adversarial air and surface threats and is compatible with variants of the F-35 aircraft. And we capped off a strong year with the historic unveiling of the B-21 Raider. The B-21 is a multifunctional platform with unmatched range, stealth and survivability, and it will be the backbone of future U.S. air power for decades to come.

We continue to perform well on the program and remain on track for first flight later this year. As the program transitions into low-rate initial production, we are working to address macroeconomic conditions, especially related to inflation and their impact on material, suppliers and labor. Importantly, I want to highlight that our B-21 unit cost projections remain below the government's independent cost estimates. The program has strong support from the U.S. Air Force, Congress and our suppliers.

And in the words of Secretary Austin from last month's rollout, "This aircraft is proof of the department's commitment to building advanced capabilities that will fortify America's ability to deter aggression today, and in the future." Our 2022 achievements underscore the breadth of our portfolio across a wide range of domains and technologies and the strong performance of the entire Northrop Grumman team.

As we look forward, defense budgets are on the rise, and we see our global customers continuing to seek proven solutions to address rapidly evolving and increasingly sophisticated threats. We are meeting their urgent needs in areas such as air and missile defense solutions, medium and large caliber ammunitions and armaments, advanced radar capabilities and global surveillance to name just a few. And we are partnering to expand our opportunity set and positioning our international business for future growth. We clearly saw increased demand in 2022, and we continue to expect to grow our international business over the next several years.

In the U.S., we are encouraged by the continued strong support for national security, including overwhelming bipartisan support for a 10% spending increase in the fiscal year 2023 defense budget that was passed in December. Our portfolio and the capabilities we offer are well supported by the administration and Congress. Growing security challenges will test our resolve in ways not seen for a generation, and we are confident this administration and the new Congress will find ways to work together to meet them.

We expect the President's fiscal year 2024 budget request to support robust funding for the highest priority capabilities outlined in the National Defense Strategy.

And our strategy has positioned us well. We're clearly maintaining our technology leadership and growing our portfolio of offerings, which is aligned to customer priorities. Another key element of our long-term strategy is keeping a laser focus on performance and driving cost efficiencies throughout the business. The current macroeconomic environment reinforces the importance of doing so.

An example of our effort is the implementation of digital solutions across the company. Beyond the benefit of transforming how we design, test and manufacture the next generation of systems, our digital initiatives are streamlining business functions and increasing productivity. We are also optimizing our facilities and consolidating our real estate footprint. Every day, we seek new and innovative ways to drive performance and increase efficiency while remaining agile and meeting our customers' expectations.

Our capital deployment strategy supports our business strategy. We are investing to not only drive efficiencies but also to allow our customers to stay ahead of the threat environment. In 2022, we invested over 7% of revenue in R&D and capital expenditures to provide the capability and capacity needed to address the threats of today and tomorrow. We also continue to return cash to shareholders.

Last year, we increased our dividend by 10%, which was the 19th consecutive increase. And during the year, we delivered over $1 billion to shareholders through the dividend and returned another $1.5 billion through share repurchases. So looking forward to 2023, we are well positioned for continued growth, and our revenue outlook has improved from the high $37 billion range we shared in October.

We now expect sales to be in the range of $38 billion to $38.4 billion, representing about 4.5% growth at the midpoint. Margins are expected to remain solid in the 11.3% to 11.5% range. We are projecting strong free cash flow growth that supports our capital deployment strategy. And we expect to return more than 100% of free cash flow to shareholders again in 2023.

Our backlog, strong recent global demand growth and our ability to deliver products that address an increasingly complex security environment give us confidence in our outlook. So with that, I'll hand it over to Dave to cover the details of our financial results and more on guidance.

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

Okay. Thanks, Kathy, and good morning, everyone. I also want to thank our team for another year of strong performance in 2022. We won several new franchise programs, delivered industry-leading top line growth and bolstered our talented workforce, with the addition of over 6,000 net employees during the year. I'll spend a few minutes on our fourth quarter and 2022 results and then discuss our future expectations in more detail, including our long-term cash flow projections.

We ended the year with nearly $79 billion in backlog, reflecting strong demand for our products and capabilities. We continue to convert our backlog into revenue at an accelerating rate with fourth quarter sales growth of 16%. This was enabled by our ability to continue strong hiring in Q4 as well as a higher volume of material receipts based on the timing of program demand. The team did an outstanding job of working with our supply chain to secure program material. And for the full year, our sales grew to $36.6 billion, representing organic growth of 3% and exceeding our prior expectations. Our operating performance and margins remained solid despite the continued pressures of the macroeconomic environment.

Our segment operating margin rate was slightly below our expectations at 11.3% in Q4 and 11.6% for the full year due in part to the impacts of inflation, which resulted in a lower level of net earnings adjustments. But margin dollar volume was very strong given the top line outperformance. A positive EAC adjustment in the quarter was on B-21, where we recognized a $66 million pickup on the EMD phase of the program, reflecting our latest assumptions regarding future incentives in that phase.

Continuing with our Q4 results, our transaction adjusted earnings per share were $7.50, a 25% increase over the same period in 2021. Higher EPS were driven by robust growth in our segment top and bottom lines as well as a lower effective tax rate. The lower Q4 tax rate was driven by the recognition of an $86 million benefit from the resolution of a legacy Orbital ATK tax return, which we previewed in our guidance last quarter. And corporate unallocated costs were also below our expectations due to lower state taxes as a result of the R&D tax amortization law not being deferred.

For the full year, our transaction-adjusted earnings per share were $25.54, well ahead of our guidance range. Now turning to cash, we had an extremely strong fourth quarter, consistent with our historical pattern. For the year, we generated $2.9 billion of operating cash flow and $1.6 billion of transaction-adjusted free cash flow, in line with our expectations. This was inclusive of a full year of cash taxes associated with the R&D tax amortization law as well as our final payment of deferred payroll taxes from the CARES Act legislation.

Moving to our pension plans, slide 7 in our earnings deck includes our latest assumptions. After three consecutive years of double-digit asset returns, our plans declined by roughly 15% in 2022, in line with market trends. Our FAS discount rate increased roughly 250 basis points to 5.54%, which was the driver of the mark-to-market pension benefit of $1.2 billion reflected in our GAAP results. These factors are also reflected in our latest pension estimates for 2023 to 2025.

As we previewed last quarter and updated in our slides today, we're projecting a decline in our noncash net FAS pension income and an increase in our estimated CAS recoveries. In total, our pension plans remain strong. As a result of the higher discount rate, our funded status has improved to nearly 100%, and we continue to project minimal cash pension contributions over the next several years.

Now turning to 2023 guidance, our revenue expectations have increased from our prior estimates, with the midpoint representing nearly 4.5% growth on top of the strong level in 2022. We expect Space Systems to remain our fastest-growing business. Sales are projected in the mid-$13 billion range, up over $1 billion from 2022 levels, with GBSD and NGI contributing nearly half of the growth and the rest coming from our broad space portfolio. Mission Systems sales are expected in the high $10 billion range, up mid-single digits, driven by restricted programs in our Networked Information Solutions business. And we continue to expect flattish sales at both Aeronautics and Defense Systems. While programs like B-21 and IBCS continue to grow, headwinds remain on legacy platforms as systems are retired. We expect Aeronautics and Defense Systems to return to growth in 2024.

And similar to our cadence in 2022, we expect first quarter sales of approximately 24% of our full year estimate, with sales ramping again throughout the year. With respect to margins, we expect our 2023 segment operating margin rate to be down roughly 20 basis points from 2022 levels. Challenging macroeconomic conditions, including extended lead times in the supply chain and high levels of inflation continue to put temporal pressure on margins. And while higher CAS recoveries provide a modest benefit to our cash flow in the coming years they create pressure in our overhead rates and EACs.

Similar in nature to what we experienced in the first quarter of 2021 when we recognized a favorable impact from lower projected CAS costs, this could lead to an unfavorable margin impact when we update our rates this quarter. We notionally expect this to have a 10 to 20 basis point impact on the full year.

In regard to the B-21 program, we expect the 2023 contract award for the first of five LRIP lots with the LRIP phase scheduled to run through approximately the end of the decade. We're continuing to work with our customer to address macroeconomic risks and enhance efficiencies in the program. As we've described in our 10-K, we do not believe that a loss on the LRIP phase is probable and therefore, no such loss is reflected in our results or guidance.

Now turning to our future outlook, we expect our 2023 earnings per share to range between $21.85 and $22.45 based on approximately 153 million weighted shares outstanding. This includes $450 million of net pension income, which represents a $4.30 per share headwind compared to 2022. Partially offsetting this nonoperational headwind is strong growth in segment performance and the lower share count, which adds roughly $0.90 of additional earnings per share and lower purchase intangible amortization largely offsets the higher tax rate.

Moving to cash. We expect 2023 adjusted free cash flow between $1.85 billion and $2.15 billion, consistent with our prior outlook as adjusted for current R&D tax law. Although we expect discussions to continue on Capitol Hill, our guidance and multiyear outlook are now based on current tax law for all years and do not include any refunds for R&D taxes paid in 2022. Capital expenditures are expected to remain elevated at $1.65 billion to $1.7 billion in 2023 and a similar level in 2024 before moderating in 2025 and beyond. This is driven by investments to support several large new business wins from 2022.

Our guidance assumes we will not have an extended CR, a breach of the debt ceiling or a prolonged government shutdown as this is our current expectation.

Slide 12 in our earnings deck provides our long-term cash outlook, which is predicated on continued top line growth in our business generating strong and gradually expanding operating margins and converting those margins into cash. R&D-related cash tax payments should decline by about 20% per year. As I described, CapEx is expected to remain near 4.5% of sales in 2023 and 2024 before starting to decline in 2025.

After investing in our business, we continue to expect to return more than 100% of our free cash flow to shareholders in 2023 in the form of dividends and share repurchases. And we plan to be in the market for new debt issuance soon to support our capital deployment plans including the refinancing of near-term maturities. In summary, 2022 was another successful year for Northrop Grumman, and we continue to deliver value for our customers, employees and shareholders.

And with that, we're ready to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Kristine Liwag with Morgan Stanley.

Kristine Tan Liwag - *Morgan Stanley, Research Division - Equity Analyst*

Kathy, you mentioned in your prepared remarks that the B-21 cost estimates is below the government estimates. But as Dave mentioned, there are macro and inflation cost pressures. I mean this comment really stood out to me since in the past decade, we've seen many large defense development programs exceed costs and not just by a smidge but meaningfully. Can you provide more color on what the Northrop team is doing to manage this risk and how we should think about the LRIPs through the end of the decade? And what are puts and takes in terms of potential risk?

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

Yes. So as we noted, we are performing exceptionally well on the B-21 program, and we have continued government support for the quantities of at least 100 that are represented in the program of record. But given that this contract was initially awarded in 2015, the recent and really unprecedented macroeconomic impact of inflation, labor, supply chain disruption has affected the cost estimates to perform on the LRIP phase of the program.

And importantly, we noted our projected cost per unit are still below the government cost estimates upon which the funding profile is based. And that's important because it supports the overall buy plan of the U.S. government. And just to, as a reminder on timing, the government hasn't yet exercised any of the LRIP options. So like we do on any priced options, we continue to look at what the future may hold and reflect that in our estimates at complete, but those are indeed estimates of cost and future performance.

So while -- as we note in the (10)K , we don't currently consider a loss on LRIP to be probable, if it were ultimately to occur, it would spread over all five lots of the program. And particularly, that's important related to any cash flow impact. So as we look at 2023, we do not see that as material in our cash flow outlook. And even as we put together our 3-year cash flow outlook, we wouldn't see that as being material. So hopefully, that gives you a sense of what is contributing to the B-21 cost estimates.

Inflation clearly is the primary driver there, as we think about what's changed recently in our estimates, and we are working to mitigate those impacts, as you say, and we have some time as we move forward and get into production to continue to do that.

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*

Maybe my first question is on Space. The performance there is better than I think anybody was anticipating. What's underlying that? And how should we think about that going forward maybe even beyond 2023?

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

Yes, Ron, you are stating it accurately the performance there has been better even than we expected, and it's largely driven by more success in competitive wins than we had anticipated. Generally in all of our business, we project a certain amount of success, particularly in competitive environments. And here, we've just done better than we anticipated. And so that's driven sales upside and the very strong book-to-bill that we've had in that business to where their backlog now is more than 3x sales and supports our projections for long-term, steady and durable growth.

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

And then you mentioned in your -- just as a follow-on in your prepared remarks that your growth has been supported by your ability to hire folks. How has that been -- I know, I mean, it's kind of across the entire industry and your supply chains, getting labor has been difficult, particularly skilled labor that's kind of up to spec. How have you guys been able to do that? And what's underlying that?

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

It has been a key driver to generating 16% sales growth in the fourth quarter, in particular. We noted in the third quarter of last year that we were starting to see labor trends change in a favorable way. Our hiring had improved. Our retention had dramatically improved, and we saw that trend continue in the fourth quarter.

I think a few things contribute: we hire technology skills that are very akin to what the technology sector employs, and we've certainly seen softness in that sector that has led to a significant increase in applications to Northrop Grumman. But I'd also like to think it's to do to the reputation of our company as being a technology innovator and the successes that we were able to showcase last year like James Webb and the unveiling of B-21 really spiked interest in applications to -- for employment at our company. And so those two things in combination are certainly working in our favor in a differentiated way.

Operator

Our next question comes from Sheila Kahyaoglu with Jefferies.

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

Just a follow up on an earlier comment. In the past, I think you've talked about 12% margins in 2024 and the 2023 guide is 11.5% or so. As you think about sort of inflationary pressures, what are you watching? And you mentioned some of the B-21 items as an example. So what sort of offsets that to get to that 50 basis points of expansion?

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

As we've noted, we had talked about 12% being the fundamental margin rate that we believe this business, this portfolio can perform at, and we would be working our way back to that as particularly mix becomes less of a headwind in the middle of the decade. We still see that. But we are having these temporal pressures related to inflation that are flowing through all of our programs, B-21 most notable because of its scale and that we bid it so very long ago.

As we think about how we are offsetting those costs, we talked about some of those ways today. We are working to digitally enable our business, which reduces program costs directly and improves profitability. But we also are applying that to our back office to streamline business processes and reduce costs that flow into our overheads also making our rates more competitive, and reducing the impact of cost growth. So those things that -- real estate has been key. You saw today, we talked about a few things that we did in the real estate area already in 2022, but we have many more of those lined up as ways to continue to offset any cost growth that we see and drive towards those higher margins.

Operator

Our next question comes from Richard Safran with Seaport Global.

Richard Tobie Safran - *Seaport Research Partners - Research Analyst*

Kathy, Dave, Todd, I think we probably all agree the stock right now seems to reflect the idea that defense is going to be a bill payer as we move to a period of deficit reduction. And I realize this question puts you a little bit on the spot forecasting government spending. But I wanted to know if you'd expand on your optimistic opening remarks. Talk about your macro outlook relative to what seems to be being priced into your stock? And if you think modernization might be sacrificed as part of the budget negotiations?

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

Yes. So we look at the stock price over a longer time horizon than weeks, and we've consistently outperformed the industry on a relative TSR basis over the long term. But as you indicate, -- we've seen some pullback in the last several weeks across the sector and even more so with Northrop Grumman. I am a little surprised at the level of relative pullback we've seen given our strong continued results, our growth outlook and the relative portfolio positioning that we have in the U.S. and internationally.

And to answer the second part of your question directly, I do not see the U.S. or our allies pulling back on funding their National Defense Strategy that is well aligned with the Northrop Grumman portfolio. So I'd sum it up by saying, with a strong backlog, growing global demand for our products, differentiated technology and the ability to attract and retain top talent, we're really well positioned to continue executing on the strategy that we have that is expected to deliver differentiated growth and a potential to generate greater than 20% free cash flow growth for at least the next several years, and we believe beyond.

So I think investors are going to like that. And we've been in periods like this before following sequestration, where there was noise in the system related to the government's commitment to national security.

But following that, it was one of the best periods of relative TSR growth at our company, and really, our industry has produced in a while. So I see this as a temporal speed bump in our path and yet our strategy remains strong to deliver value.

Richard Tobie Safran - *Seaport Research Partners - Research Analyst*

Just as a quick follow-up on inflation. The comments on the B-21 that you've been making, is there a general trend here? When your contracts you're signing right now with the government, are they generally accounting for inflationary effects or are you not finding that?

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

So our customers are engaging in conversations with industry to understand ways to motivate our investment in future capability and capacity, that is what they really want. And I think many of them now understand that shifting too much risk to industry doesn't support that investment, nor does it deliver the capability they need in a timely fashion. So with that, I expect we're going to see less fixed price development going forward. And with regards specifically to inflation, the industry broadly is pushing back on accepting long-term fixed price contracts right now. And they're asking for reopeners for inflation. We expect that to continue. And as our suppliers ask us for that, we, of course, are passing that on to the government. And really, that's just common sense. So I believe it will become the norm.

Operator

Our next question comes from Douglas Harned with Bernstein.

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

Last year, you had a decline in Aeronautics that we understood pretty well because you've got quite a few legacy programs that were ramping down, like JSTARS, Global Hawk. When you look at this year, with your fairly flat guidance for Aeronautics, how do you look at the pluses and minuses when we look at B-21 growth but you still got some legacy programs that are declining. How do you see those offsetting each other?

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

So Doug, this year is really a continuation of those same trends flowing through the top line. The programs that have been declining, we've seen the majority of those declines, but they do still flow into the '23, '22 compare. So it is things like Joint STARS and Global Hawk. F-35 being a big revenue contributor in AS is relatively flat. So that ties directly into the narrative about their revenues being flat. And then B-21 is an increase, but it's not a significant increase yet because we're just moving from EMD into LRIP and those two combined are not a significant increase in the program as of yet.

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

Well, and then on a slightly different topic. When you look at rocket motors, and this is an important area for you. And I'm trying to picture what the growth trajectory looks like. And also just in a sense of your market share, you've got one competitor that is a mature player. There are new entrants coming into the space. How do you see the long-term evolution of your market share and how you're positioned in that area?

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

So we stay focused on investing in the future capability needed and more so lately in the capacity needed. And in many ways, the reason we are being asked to take on more share of the market is because we've been investing in this business and are able to take on that additional business because we have outfitted our manufacturing facilities to support the growth. That's what the government is asking, we have been responsive. And so as a result, we are winning more business in that area. But we expect to be able to compete even as other new entrants come into the space because we do have a long heritage of expertise that contributes to our solid rocket motor business.

And that's for all size, as I talked today and highlighted some of the larger solid rocket boosters that we build in support of SLS and GEM 63 for Kuiper. But that's true in businesses like GMLRS, where we are taking on more of the needed capacity because we've been investing in our manufacturing capacity there as well.

Operator

And our next question comes from Seth Seifman with JPMorgan.

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

I wonder if you could talk a little bit about the profitability in the Space business. The margin guidance came down there, margin rate guidance came down there a couple of times during the year. And it's kind of perceived to be kind of a 10% business, I think, is what we've talked about in the past and looking to a second year in the mid-9s here in 2023. So what's changed there over the past year?

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

Seth, it's Dave. So I think you pointed out accurately that we're now projecting a margin rate for Space in the mid-10s going forward. There were a lot of puts and takes in that margin rate upward and downward throughout 2022. Obviously, it's a rapidly evolving business, a tremendous amount of backlog growth and new program activity added into that portfolio over the last couple of years. So we're really pleased with the volume we're adding both at the top line and the bottom line in that process. Obviously, a lot of new cost type work being added to that portfolio and that mix growing, but also work that will evolve toward fixed price over the next couple of years and some new fixed price programs in that mix as well.

So in aggregate, we think the mid-9s is the right way to look at 2023. In the coming years, we do see the opportunity for margin rate expansion. But I think the most important takeaway for the Space business is that the volume of top and bottom line growth that we've been delivering over the last couple of years and now are projecting over the next few is really adding a lot of value there.

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

Okay. Okay. Great. And then just as a follow-up, Dave. So the working capital performance was quite good in '22. I think the way that we're measuring here, working capital actually came down a bit despite the growth and despite the tough operating environment, only 6% of sales, which is below some of your peers. What's the opportunity from here? Or is there kind of a normalization at some point where actually for a growing business, the normal level of working capital is higher?

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

So let's talk about that for a few minutes. There is not a substantial change in working capital projected in the three-year free cash flow guide that we gave today. There is more capital intensity in 2023 and 2024 that we've signaled throughout this year, given just how much more new business we were awarded this year and the additional capital investments that we need to make to support capacity and capability there.

We've talked about things like the Amazon Kuiper Award and other areas of the business that Kathy just noted, that we're making investments upfront for these long-term franchise programs. So that is a headwind to free cash flow. But we're pleased to be able to offset that and deliver free cash flow guidance for '23 that's in line with our prior expectations. That's supported by the growth of the business, both top and bottom line. The R&D tax numbers will come down steadily over the next five years. And then gradually, over the next several years, we'll see improvements in the CAS pension cost reimbursement based on current projections.

So not much change in working capital, but there are some other moving pieces in the mix. I think importantly, when we look at the underlying fundamentals of growth and margin rate, as we talked about in our scripted remarks, we do anticipate growth through this three-year outlook that we've provided at the top line, and we are modeling a small but gradual improvement in the margin rate as well. So that's a healthy underlying condition for free cash flow.

And while we're at it, as we think about this outlook for free cash flow, the foundation is set for strong free cash flow beyond this three-year period. The second half of this decade will have more programs moving to production, fewer of these upfront investments required to do so. The foundation we've laid over the last several years of capital investment is going to pay off in the second half of this decade on many of those programs. And so that's a healthy environment for continued growth in free cash flow as well as the continuation of the R&D tax amortization rolling off as a headwind.

So when you look at the second half of the decade, I think your expectation should be more of the same strong growth in free cash flow that we've been talking about in the first half.

Operator

And our next question comes from Myles Walton with Wolfe Research.

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

I did have a couple of follow-ups on the B-21, if that's okay. And Dave, I think you alluded that the first LRIP contracts to be awarded in '23. I'm just curious, is that sort of the triggering event of whether or not you'd know you're in the loss or not at that point? And then Kathy, I know you said the 10-K disclosure is over the five LRIP lots. But I'm just curious, is it tougher at the front end of those lot profiles? Is it more promises at the back end that you'd have time to fight off inflation? Anything on those two fronts?

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

Sure. I'll start on your first of those questions. The award of that first lot of LRIP will be a noteworthy event but not a triggering event of any kind from an accounting perspective. We will update our projections quarterly as we have been. We'll continue to do so.

And so at this time, we don't believe that a loss is probable and therefore, we have not booked one. We do believe that a loss is possible, which is why we're including it in our remarks and our 10-K disclosures. It's something we will continue to work over time. Obviously, this is going to continue for a number of years. As Kathy has talked about, we'll continue to do everything we can to mitigate inflationary pressures and work with our customer and our suppliers in the process. Kathy, anything you'd like to add?

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

Sure. So in answer to your second question, we do expect to have a better sense as the year progresses, and we'll update disclosures as we do. And as we look at the profile, there's nothing really notable. To your point, we have more time to work cost efficiencies in the later lots. But of course, we made some more aggressive assumptions about learning curves and the like as we would on any production program. So really nothing notable in the profile and how you might think about any potential loss being spread.

Operator

Our next question comes from Robert Stallard with Vertical Research Partners.

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

Dave, I've got a couple of cash flow questions for you. First of all, on basic cash taxes with the R&D tax legislation impact. What sort of tailwind are you expecting from this -- from 2023 and onwards? And then secondly, what are your assumptions for equipment sales in that cash flow guidance for 2023 or for the whole period?

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

Sure. Thanks for those questions. The answers are pretty straightforward. As we noted, the impact on our cash taxes in 2022 from the R&D tax legislation was just under $1 billion. We would anticipate that being about 20% less per year, just under $200 million or so on average less per year. And so that is the magnitude of the annual tailwind that we'd anticipate for the next five years or so. Overall, cash taxes, excluding the impact of that R&D tax amortization will increase slightly over the coming years, but that's factored into our multiyear outlook.

And as for equipment sales, I appreciate the question there. We received the final payment associated with the equipment sale that we booked a couple of years ago in 2022. And so we don't anticipate or have in our multiyear cash flow outlook, any continued recoveries from equipment sales.

Operator

Our next question comes from the line of Cai von Rumohr with Cowen.

Unidentified Analyst

This is actually Jack on for Cai today. Just a quick question back to kind of the Section 174, Dave, I know in the past, I'm not sure if you quantified that if you could actually provide that dollar figure if you could. I know it steps down 20% each year. But looking back at your guide from last year at this time for '24, it looks like a larger delta than an implied $700 million headwind. So just to confirm, is that incremental CapEx going higher? Or if you could just provide some color there, that'd be helpful.

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

Sure. I appreciate those questions. I think you have to the air math about right on 174. It was just under $1 billion in 2022, and it will decline by just under $200 million a year on average going forward. In terms of that 2024 guide, you're right that our CapEx expectations increased a bit given the volume of new business that we won this year that we'll be investing in going forward. No other material changes to 2024. We do anticipate growth as we've seen in '24 and then a real ramp in '25 as CapEx begins to decline, and you have the tailwinds as well in '25 and beyond from R&D tax, CAS pension recoveries and the underlying growth in margins in the business.

Operator

Our next question comes from Peter Arment with RW Baird.

Peter J. Arment - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Kathy, within Aeronautics, the service mix continues to be a bigger part of the story. I guess it's now about 22%. If you finish 22 and look, that's up from the mid-teens the last few years. Obviously, there's some puts and takes on why that is. But just wondering if this trend is going to continue and how you think about the impact on margins?

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

Yes. So we do expect the trend to continue in terms of -- as assets get into service, we continue to support them. But we also have assets like Global Hawk that are coming down. So I don't see a material change in that mix as we look forward, Peter.

Operator

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

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

Kathy, in your opening comments, I think you maybe called out international opportunities, perhaps a little bit more than I can remember from recent quarters. Can you help frame maybe how much of an uptick in international opportunities could be reflected or international sales could be reflected in the '23 guide, if that was all a part of any of the upward revision -- and then as you think about beyond '23, how meaningful is international in terms of an uptick for you? I know historically, obviously, it hasn't been as meaningful as part of the mix of some of your peers, but maybe you can comment on that expanding opportunity set?

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

Yes. Thank you. So in the fourth quarter, we did see some meaningful uptick in Defense Systems, and you can see that reflected in our results, both from the areas that I outlined in this call related to ammunitions and armaments but also increased interest in IBCS, and we have the current Poland work continuing to ramp but the 10 additional countries that I've noted that have expressed interest. So as we think about the near-term drivers, it's the things that we already have in production. But as we think about the longer-term drivers is areas like IBCS future sales.

And we are seeing that interest increase across the business, but most notably in '23, I think you will see that reflected as upside opportunity in Defense. As we look at the enterprise over the next several years, we do expect our international growth rate to be double-digit, low teens compared to a U.S. growth rate that's more in the norm of our mid-single digits. So as we think about international, we do expect it to grow as a percent of our portfolio in the next several years. And that's all based on international demand growing as a result of increased spending confirmations made by our allied partners.

Operator

Our question comes from Scott Deuschle with Credit Suisse.

Scott Deuschle - *Crédit Suisse AG, Research Division - Research Analyst*

Kathy, if I go back to 2018 when the group sold off quite a bit, Northrop got pretty active on buying back stock. And I think you even launched an ASR, if I recall correctly. So I'd be curious if that would still be your playbook this year if the valuation continues to come down? And whether you might lean on the balance sheet to do so just given the track record of having run a valuation-sensitive buyback program?

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

Yes. Well, as you note, we have used ASRs as a tool in the past. And as we indicated in the call today, we do plan to put more than 100% of our free cash flow back into the deployment to shareholders. The fact that our valuation is down, really, we don't try to time the market per se. But we do think about that as we are contemplating what our options are for capital deployment this year, and we do have the flexibility to increase share repurchase from our original plan. So that is something we're actively contemplating.

Operator

Our next question comes from George Shapiro with Shapiro.

George D. Shapiro - *Shapiro Research - CEO and Managing Partner*

Dave, I had one for you. In the operating income discussion in Space, you had a big gain, $45 million charge. And you said it was all -- the $96 million gain only partially offset the lower EACs. When I look at the (10)K for the year, you had minus $38 million in Space versus $134 million last year. So if you kind of just discuss what happened in the quarter and just why such a significant change year-over-year?

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

Sure. Well, that's a great question, George. Clearly, that's an indication of the broader macroeconomic conditions that we in our industry, and frankly, most other industries were facing in 2022. And in our business, it impacted the level of net EAC adjustments in really each of our sectors in different ways. And you see it acutely there in Space, as you mentioned. A number of those EAC adjustments were in the fourth quarter. And that kind of -- the net of all those puts and takes to include the inventory adjustment on a new commercial product line that you mentioned was another downside in Q4. Those were roughly offset by the upside from the land exchange transaction in Space. So a number of puts and takes, but when you net it all out, not much overall impact on the Space margin rate in Q4 or for the year.

We're forecasting a rate just above that level that we operated at in '22 as we now look at '23. And as I noted earlier, something in the mid-9s is our kind of going forward expectation for '23 margin rate in Space.

George D. Shapiro - *Shapiro Research - CEO and Managing Partner*

But Dave, it's still unusual to see negative EACs for the year. So I was just wondering, are there any specifics that you could point to maybe was for the year or just for this quarter?

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

No single item was a driver of that of much more significance than any other. I think that alone, George, is an indication of the fact that this was more in line with broader macroeconomic pressures as opposed to any performance issue or contract issue in any particular program. This was broader and more widespread, but not significant on any one program in and of itself. And again, I think really just indicative here of the environment we were operating in, in a business with a lot of programs, a lot of new growth in recent years to be excited about.

George D. Shapiro - *Shapiro Research - CEO and Managing Partner*

Okay. And then just one general one for you, Kathy. I mean, with the better sales growth you're guiding to in '23, a result of the budget or new awards won or both? And then also, with 16% sales growth in Q4 and outlays is likely to grow 7% or 8% in '23 based on the budget investment authority of 15. Why does the growth rate slow that much in '23? I mean why wouldn't it be higher than what you're suggesting?

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

Yes. So as we noted throughout 2022, if we could break loose supplier deliveries and continue to improve labor trends, we could deliver accelerated growth. And fourth quarter exemplified a path to doing just that. As we come into 2023 with that momentum, the same holds, we are confident enough in our sales expectations as we sit here today to raise them above what we had said in October, largely because we are seeing those improvements in labor in particular.

And if those trends continue, we would have opportunity to even further accelerate growth in 2024. The budget does not play into this. We had assumed strong budget growth. It, of course, came to fruition in the '23 budget, and we continue to believe the '24 President's budget will also show growth.

Todd Ernst - *Northrop Grumman Corporation - Corporate VP and Treasurer & VP of IR*

Norma, we have time for one more question.

Operator

Our next question comes from the line of David Strauss with Barclays.

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

Great. Thanks for fitting me in. A lot of discussion on B-21 and EMD and LRIP. Just -- how should we think about what happens to AS margins over the next couple of years as I assume EMD flattens out or starts to come down where you've been taking positive adjustments and LRIP ramps up from here?

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

David, I'll start on that one. Our margin rate was particularly high in AS in 2022. That was driven in part by the strong performance on those EMD profit pickups associated with anticipated incentives on that part of the program. We projected a 10% or so level for AS margins in '23 and expect that, that's a reasonable kind of planning assumption at this point for '23. And as we look forward beyond that, a lot of the factors that are working into the '23 estimate would be those that we'd expect to continue beyond '23. So of course, we'll update you over time.

You mentioned B-21 EMD program, will -- a portion of the contract will continue for a number of years. On LRIP, we haven't baked any margin or cash in that part of the program into our multiyear outlook or our '23 guide. So we think that 10% level is the right way to think about kind of the underlying margin rate in AS in the near term.

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

Okay. And Kathy, maybe your thoughts on what bookings could look like this year, what you're anticipating for the book to bill this year?

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

Yes, David. So we had projected book-to-bill to be light in 2022, and it turned out to be 1.07x. We are projecting it to be light again in 2023. I've noted before, we look at this over a multiyear period. We've been running at 1.2 for the last four years aggregated across those four years. So we still expect to be well over 1x when we think about a 5-year aggregated book-to-bill, but we do expect 2023 to be less than 1x.

Todd Ernst - *Northrop Grumman Corporation - Corporate VP and Treasurer & VP of IR*

Alright. Great. Thanks. Kathy, over to you.

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

So look, 2022 was another year of outstanding performance by the Northrop Grumman team, and I want to thank them. As we reflected on our call today, we're even more encouraged with the opportunities for continued growth and value creation for our company in 2023 and beyond. So hopefully, that conveyed to you. Thanks again for joining our call today.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect. Everyone, have a wonderful day.

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