REFINITIV STREETEVENTS

EDITED TRANSCRIPT

NOC.N - Q2 2023 Northrop Grumman Corp Earnings Call

EVENT DATE/TIME: JULY 27, 2023 / 1:00PM GMT

OVERVIEW:

Company reported free cash flow of $1 billion, cash of $600 million, free cash flow of $600 million, cash of $360 million, free cash flow of $3 billion.

CORPORATE PARTICIPANTS

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

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

Todd B. Ernst *Northrop Grumman Corporation - Corporate VP of IR*

CONFERENCE CALL PARTICIPANTS

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

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

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

Jason Michael Gursky *Citigroup Inc., Research Division - Research Analyst*

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

Matthew Carl Akers *Wells Fargo Securities, LLC, Research Division - Senior Equity Analyst*

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

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

Richard Tobie Safran *Seaport Research Partners - Research Analyst*

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

Robert Michael Spingarn *Melius Research LLC - MD*

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

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

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

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to Northrop Grumman's second 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 B. Ernst - *Northrop Grumman Corporation - Corporate VP of IR*

Thanks, Josh, and good morning, and welcome to Northrop Grumman's Second Quarter 2023 Conference Call. We will refer to a PowerPoint presentation that is posted to the IR website on the call this morning.

Before we get started, 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.

And 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. As you saw from this morning's earnings release, global demand for Northrop Grumman's solutions is driving exceptional growth. In the second quarter, our sales were up 9% with solid contributions from each of our four business segments. Our ability to hire and retain talent and improving supplier deliveries are strengthening our top line. Given our year-to-date sales increase of 7% and an improved outlook, we're increasing our full year sales guidance range by $400 million. In addition, award volume in the quarter was robust, with a book-to-bill ratio of 1.14. As a result, we're increasing our full-year book-to-bill projection to approximately 1.0.

Our $79 billion backlog continues to be more than 2x our expected 2023 sales supporting our long-term growth outlook. We delivered solid second quarter earnings per share of $5.34, and we're increasing the lower end of our full year guidance range by $0.20. And free cash flow was healthy in the quarter, more than $1 billion higher than Q2 of last year, positioning us well for our full year target.

Turning to the budget environment and starting with the U.S. We're encouraged by the continued bipartisan support for national security funding to implement the Administration's National Defense strategy. The FY '24 budget and recent congressional committee bills prioritize modernization, including areas of strength in our portfolio such as the Triad, the Space domain, information superiority and advanced weapons. We also anticipate continued support for Ukraine and related emergency spending, which would represent even further increased demand.

Global demand for our products also continues to grow as our allies increase defense spending to address evolving threats. We are well positioned in multiple markets to meet this demand with programs such as AARGM, IBCS and E-2D as well as munitions. With a robust backlog and a leading growth outlook, I'd like to now spend a few minutes outlining our path to margin expansion, which is a key element of our earnings and cash flow growth plans.

Our 2023 operating margin dollar guidance is in the range we've previously provided. This guidance implies a segment margin rate in the mid-11% range in the second half of 2023, having delivered a rate of 10.9% in the first half. We also see an opportunity to increase our year-over-year margin rate in 2024 and get to a 12% target in the longer term. Achieving this margin improvement is built on three key drivers: First is the stabilization of temporal macroeconomic factors that have driven higher costs and impacted our supply chain and labor efficiency. Second is the ongoing implementation of cost management programs across the company that help drive affordability, competitiveness and performance. And third is our business mix, which we see shifting to more international and production contracts as international demand grows and many of our current development programs mature over the next several years.

With regard to the macroeconomic factors, supply chain disruptions rooted in the pandemic and the subsequent labor market tightness have created program delays and cost growth. To reduce this disruption, we're buying ahead of schedule, pursuing second sources where it makes sense, and placing more of our people at suppliers to facilitate timely material deliveries. We see signs of progress across our supply chain from these actions, and we are seeing fewer new issues emerge.

We've had exceptional performance in growing our headcount since the second half of 2022 and attrition rates are down to pre-pandemic levels. Our focus now is on optimizing labor efficiency, which is an important driver of profitability. To accelerate the learning curve for our employees, we're leaning forward with innovative training programs and standardizing work instructions.

Inflation has been a challenge for our industry as well as others.

Cost growth has now begun to moderate, but the last 18 months of inflation continue to have a higher base effect on our costs, especially in labor. If you look at our year-end 2021 fixed-price backlog, it was largely priced before we began to experience elevated levels of inflation. However, of that backlog, approximately 70% will have been converted into sales by the end of this year. And for new bids, we are factoring higher inflation expectations into our contracts. We're also working to drive additional discipline in our bid approaches, particularly on fixed-price contracts to help protect against these types of dynamics in the future.

Overall, we anticipate that these macroeconomic impacts have stabilized and now have largely been incorporated into our margins or risk factors.

The second key driver of margin opportunity is cost management, which benefits both affordability and competitiveness. We are laser focused on overhead cost reductions. A foundational element of these reductions is our implementation of digital solutions across our business, which will help to drive performance and productivity. For example, we've built a digital ecosystem that focuses on program execution, bringing together employees, customers and partners into an integrated environment so they can seamlessly work together. This accelerates design, integration, testing and deployment across programs, helping us to deliver with quality, speed and efficiency. We're increasing the number of programs that are operating in this ecosystem, and today, we have over 100 active programs that are doing so.

We're also investing in and advancing the technologies and digital systems in our factories. We're scaling this across the enterprise to drive efficiencies that should benefit all of our stakeholders. For example, on the B-21, we've successfully demonstrated the use of this digital thread tied to advanced manufacturing technologies to realize over 15% labor efficiencies in one area of the build. And in June, we launched the expansion of this approach across the whole build process. We're extending this digital thread into our business operations to deliver further benefits across the company. This includes how we're managing our supply chain, where we've broadly centralized procurement and we're working to leverage our purchasing power to reduce costs.

We have over 20,000 suppliers, and we've begun securely connecting them into our digital ecosystem. Over the next several years, we expect to have the majority of our supply base fully integrated. This is expected to lower supplier costs and significantly improve productivity.

The third key area of margin opportunity is our business mix. For several years, we've had one of the highest cost-plus development contract mixes in the industry, reflecting our significant early-stage position on key franchise programs, which will transition to production throughout this decade. This cost-plus mix has been increasing, with our first half revenue at 55% cost-plus, up from about 50-50 last year. Looking forward, we see this shifting towards more fixed-price revenue, rising to approximately 60% of sales by 2027 as a number of large programs in all four of our sectors transition to production.

Production program margins are typically a few points higher than development margins, so mix shift can contribute meaningfully to our segment operating margin rate. And we are making good progress on moving programs through development and into production. For example, AARGM-ER completed its fifth consecutive test flight in the second quarter. This program is nearing completion of its development phase and is on track to ramp production volumes next year. And on B-21, we successfully powered on the first flight test aircraft in the quarter, another important milestone in our campaign to achieve first flight and transition to production.

We also expect our international business to grow at a double-digit rate over the next few years, improving our margin opportunity as global sales become a larger percentage of our mix. In the second quarter, we demonstrated our IBCS solution for eight potential international customers, reflecting growing demand for this advanced air and missile defense capability. We also signed a memorandum of agreement with Rheinmetall to expand capacity for F-35 center fuselage production in Europe.

We expect these three drivers to result in improved affordability, even better performance and higher margins. When combined with the strength of our backlog and increasing global demand, these operating margin improvements should provide the foundation for strong future free cash flow growth.

Now with respect to capital deployment, we're executing a strategy that prioritizes investments to support our business plans and returns cash to shareholders. In May, we increased our dividend for the 20th consecutive year by 8%. Year-to-date, we have returned $1.5 billion to shareholders and are on track to meet our goal of returning more than 100% of free cash flow this year. Overall, the global defense budget outlook and our alignment with customer priorities give us confidence in our growth trajectory. We are focused on margin expansion opportunities and converting this to free cash flow growth to deliver value both for our customers and our shareholders.

So with that, I'll hand it over to Dave, and he'll cover details of the second quarter financial results and updates to our full year outlook.

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

Thanks, Kathy, and good morning, everyone. We're pleased to report another solid quarter. We remain focused on executing our strategy and believe we're well positioned to grow our top line, earnings and cash flows for years to come. The demand environment continues to be robust, supported by the alignment of our portfolio with our customers' highest priority missions. And as Kathy described, we see a path to expand margins in the second half of this year and beyond as macro pressures ease and we drive efficiencies into our business as it grows and experiences mixed tailwinds.

Now turning to Q2 results. we generated $10.9 billion of new awards, a higher total than we previously expected. Our book-to-bill was 1.14 and was driven by restricted awards of $5.4 billion. This brings our year-to-date total to $8.6 billion in restricted bookings. Looking forward, we expect a number of production awards in the second half of the year, including the first lot of B-21 LRIP.

Moving to sales on Slide four in our earnings deck, we delivered strong top line growth of 9% in the second quarter, building on the momentum from Q1. As a result of our success in bringing on new employees, incremental improvements in the supply chain and continued backlog strength, our sales are growing at a higher rate, and we've increased our full-year guidance. With respect to segment results, all four of our businesses grew in the second quarter. Space continues to lead the way with their second consecutive quarter of 17% sales growth as GBSD, NGI and restricted space programs continue to ramp. And Defense Systems sales increased 10% on the strength of their armaments and missile defense franchises. Mission Systems growth of 5% was driven by restricted programs in the Network Information Solutions business, and Aeronautics Systems returned to growth as higher volume on restricted programs outpaced the headwinds on legacy programs as we've anticipated.

Turning to Slide five. Segment margins in the second quarter were 11%. Keep in mind that Q2 of last year included over $70 million, or 80 basis points, of benefit from a land sale and a contract-related legal matter. Most importantly, margin dollars improved incrementally from Q1, largely meeting our expectations. Program performance remains strong across the portfolio, as the team does a good job in navigating the lingering disruption from the pandemic and macroeconomic factors we've been discussing. One area of pressure we experienced in the quarter was a $36 million unfavorable adjustment on NASA's Habitation and Logistics Outpost program, or HALO, in our Space Systems sector.

Moving to earnings per share on Slide six. Diluted EPS in the second quarter were $5.34. This included lower net pension income of roughly $1 per share, partially offset by more favorable returns on marketable securities than in the same period last year.

Slide seven highlights the non-operational pension headwinds we experienced in Q2. On a year-over-year basis, 2023 pension income will be lower for all periods when compared to 2022, but these headwinds are expected to dissipate as we look to 2024. With respect to cash, we generated strong free cash flow in the second quarter of over $600 million, a significant increase compared to the same period last year, in which we had an outflow of $460 million. This improvement was driven by increased billings and timing of collections across the company. We paid roughly $360 million of cash taxes associated with Section 174, and we continue to expect a full-year impact of a little over $700 million.

Moving to 2023 guidance. I'll start with a few updates to our sector estimates, which you can see on Slide eight. Our Space business continues to deliver outstanding sales growth and bookings, demonstrating the strength of its diverse portfolio of capabilities. As a result, we're increasing sales guidance for Space to the high $13 billion range. Remember, as recently as 2019, this business was generating revenue in the mid-$7 billion range. So our guidance this year reflects a fantastic 4-year CAGR of roughly 17%. At Defense Systems, based on the strength of their year-to-date results, we're increasing our full year expectations for this business to the mid- to high $5 billion range. This represents growth in the low single-digit range. There are no changes to our revenue expectations at AS or MS. With respect to margin rates, we're maintaining our expectations for AS, DS and MS, and we're projecting a lower operating margin rate at Space to reflect the rapid increase in new program wins and their first half results.

At the company level, this translates to an increase to our sales guidance of $400 million and a growth rate between 5% and 6% for the full year. We're maintaining our expectations for segment operating income dollars. We expect a slightly higher full year tax rate of 17%, and we've reduced our projection for shares outstanding to the mid 152 million to reflect our latest share repurchase expectations. Our EPS outlook continues to assume Q3 closure of the sale of the minority investment for which we increased our full year EPS guidance by $0.40 last quarter. This quarter, we're increasing the lower end of our guidance range by $0.20.

We remain on track with our full year outlook for cash and continue to expect to grow our free cash flow to about $3 billion by 2025. This represents a greater than 20% CAGR, driven by the growth of our business and structural tailwinds from cash taxes, lower CapEx and higher CAS recoveries. And over the next five years, we see an opportunity to approximately double our current level of free cash flow.

Lastly, we continue to execute our balanced capital deployment plan. This includes investments of over $2.8 billion in R&D and CapEx this year and returning excess capital to shareholders via our quarterly dividend and share repurchase plans. For the year, we continue to expect to return over 100% of our free cash flow to shareholders, including roughly $1.5 billion in share repurchases. We also plan to retire $1 billion of notes that mature in August, and we don't have any additional bond maturities until 2025. Overall, the Northrop Grumman team delivered a strong first half of the year. Our business strategy is working, and we're continuing to drive additional growth in sales, earnings and cash. With growing global demand for our portfolio of solutions and solid program performance, we're building long-term value for all our stakeholders.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Robert Stallard with Vertical Research.

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

A couple of questions from me. First of all, Kathy, thanks for your commentary on the margin expectations for the next few years. But I was wondering, as you talk about this, what are you expecting on the B-21 LRIP? Is that still anticipated to be around a sort of breakeven margin in your expectation? And then secondly, does the end of the F-18 have an impact on this?

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

Rob, thanks for the question. So as we look at the profile going forward for B-21, as we've noted before, we are not planning to have margin from the LRIP contracts. So when I talk about our margin projections going forward, it anticipates that. I will remind you, we still have the risk factor associated with B-21 as we look at inflationary impacts. In the quarter, we did receive notification that the DoD has allocated $60 million for B-21 LRIP procurement due to inflationary impacts and we expect that to be awarded later this year. But keep in mind, this only applies to the one fiscal year it's associated with, FY '23, and we continue to work closely with the government on an effort to address the impacts of macroeconomic disruption.

With regard to your question about F-18, yes, our projections also incorporate the wind down of the F-18 production line. We've been anticipating that. It is built into our plans as we think about our production profile over time. That mix is being driven not just with Aerospace programs like B-21 transitioning into production and F-35 continuing to grow. It is built on our entire portfolio, all four of our segments will see program shifting from development to production in that time frame and that mix shifting.

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

Okay. Then just a quick follow-up on the HALO program. Could you clarify if this is a fixed-price development program or if it has a different contractual structure?

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

It is a fixed-price program. We had worked with the government in a cost-plus structure through the preliminary design review. So we had a more mature design before transitioning into a fixed-price contract structure. And as I noted in my comments, we are being even more disciplined moving forward in ensuring that we work with the government to have the appropriate use of fixed-price contracts. We think that is best applied for commercial items or production programs with stable requirements and mature design. As it's turning out on the HALO program, the requirements are not as stable as we or the government anticipated, and we're working with them to address that change management as we go forward.

Operator

Our next question comes from Richard Safran with Seaport Global Partners.

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

So you've been a bit reluctant to talk about this so far, but I thought I'd see if you'd comment on the NGAD sixth generation fighter program since the Air Force just recently announced the competition. What I'd like to know is if you're thinking about bidding this as a prime. And I'd also like to know if you could -- if this program is considered part of your growth strategy. So any color you could provide there would be helpful.

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

Thanks, Rich. Yes, before the government officially announced the program and their intent to issue the RFP, we had been quiet, but we have notified the U.S. Air Force that we're not planning to respond to the NGAD RFP as a prime. We are responding to other bidders' request for proposal as a supplier. That's particularly in our Mission Systems portfolio. And as I noted in my remarks, we are remaining disciplined in assessing the right programs to pursue, and that's ones where we feel we're well positioned with a mature offering. And where the business deal reflects an appropriate balance of risk and reward for both the customer and the industrial base. So the no bid decision on this program doesn't impact our path to sales and earnings growth at NGAS. We have a strong backlog in that sector, and we have other opportunities in military aircraft that we are pursuing.

Operator

Our next question comes from Ron Epstein with Bank of America Merrill Lynch.

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

I guess I have to dig down a little bit further on that. Would that no bid also cross over to F/A-XX, or do you -- is that a related program or a different program? How should we think about that? Or is that one -- you'd want to be a supplier on as well?

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

Well, I'll just say that when I noted we have other opportunities we are pursuing, I won't disclose at this point exactly what those are until a little more information comes out on other programs. But you could assume that if we feel we're well positioned, and the government is appropriately balancing risk and reward, as they said, that would be a program we would pursue.

Operator

Our next question comes from Kristine Liwag with Morgan Stanley.

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

Maybe following back up on those 2 questions. I mean, not bidding as a prime at NGAD. Kathy, is this part of your strategy in terms of maintaining margin growth in the next few years? Because when you look at historically, you guys had walked away from T7. You'd walk away from the tanker and avoided the winner's curse. Is that how to think about the strategy for this program? Or are there other factors in play that we should consider?

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

Well, Kristine, certainly, your words not mine, but we do feel that discipline has served us well in the past in selecting how much risk to take and what to pursue. And we've learned lessons from some of our own experience as well. So we are applying those as we think about what to bid and what not to bid going forward. And that is critical to us expanding our margins back to what investors expect of this company. And it's the three factors I mentioned, but bid discipline and ensuring we have the right combination of risk and reward is important. And it's not just important for us to be able to meet our commitments to our investors, but for the entire industrial base to remain healthy so that we can have an industrial base that investors want to invest in.

Operator

Our next question comes from Doug Harned with Bernstein.

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

On the margin question, when we look at history, generally, inflation, it doesn't affect defense companies that much. And we've obviously seen a very difficult two years where it rose, and you've talked about this, rose very quickly and you've had to absorb costs in fixed-price contracts. When you look forward, you talked about being able to run out some of the contracts that were priced before we had that higher inflation level. But when you look at repricing contracts that go into next tranches, new work, do you expect that you're going to be able to get back to be able to price off a base cost level that can allow you to have the same kind of performance we saw in a sense in the pre-COVID era?

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

Yes, Doug, we do expect that to be the case. The government will look at the actuals that we have experienced and the inflationary pressures are absolutely showing up, not only in labor but materials, which then provide us the basis to work with the government and negotiate off of those higher costs in the future contracts.

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

And then clearly -- and it sounds like you're looking at this over the next 12 months or so, you should see this shift. But clearly, it also requires more money in the budget. We saw a lot of money coming in, in the '23 budget from the Senate last year, but you're expecting then the budget to also be able to cover these higher costs?

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

I expect that the budget will need to incorporate these higher costs. To the extent that inflation exceeds the growth of the overall budget, there could of course be supplementals, or priorities will be made in terms of what the government will buy. And we're already seeing this where the government is having to reduce quantities on programs from their anticipated levels to address the higher cost coming in based on inflation, and we expect that to continue for the foreseeable future as these contracts come up for renewal.

Operator

Our next question comes from Sheila Kahyaoglu with Jefferies.

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

I want to ask about Space specifically, please. Your revised guidance takes into account $1.6 billion of sales growth in 2023. Can you maybe bucket this growth for us? Where is it coming from? How much of it is GBSD? And how do we think about the margin implications of this growth given the quarter?

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

So a good bit of the growth has been and continues this year to come from two programs, GBSD and NGI. We have talked about that being approximately half of the growth. And the other half coming from a broad set of programs, but most notably, our national security portfolio, which is about 80% of our overall revenue in the Space business. And the margin profile is similar across those businesses, with early phase development being lower margin as we shift into production like we talked about earlier on the call, will present the opportunity for space margins to continue to expand.

But we're really pleased with the 9% that we're seeing there. Obviously, we're going to work to get that closer to 10% through the work that we're doing, both on performance and in the longer term as mix shifts, we see it have the potential to go even higher. But when you look at 9% for a business that has absorbed that type of growth and been able to continue to manage through the disruption of the macroeconomic environment, we feel like we're in a good place.

Operator

Our next question comes from Matt Akers with Wells Fargo.

Matthew Carl Akers - *Wells Fargo Securities, LLC, Research Division - Senior Equity Analyst*

I wanted to ask about Sentinel. I think there was a GAO report during the quarter that talked about maybe some scheduled risk on that program. I think it's cost-plus anyway, but just your thoughts on how that program is going, if there is maybe any risk to you guys on that.

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

Yes. Thanks for the question. So this is in regards to Sentinel or GBSD, as many of you know it. And there was a GAO report that spoke of schedule pressure. We've been talking about that and the U.S. Air Force has as well as we have seen disruption in supply that has flowed through to schedule pressure on the program. We're in the process of working with the Air Force on looking to optimize the schedule to see what we can pull left, what obviously is shifting right, and how we can maintain the initial operating capability date, which is the primary focus of the government so that we can replace those missiles in the silos as anticipated later in the decade.

Matthew Carl Akers - *Wells Fargo Securities, LLC, Research Division - Senior Equity Analyst*

Okay. And then if I could follow up, I guess, maybe on working capital, Dave, I don't know if you could just comment on your thoughts on how that progresses in the second half?

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

Sure. Thanks, Matt. We continue to feel really good about our working capital status as efficient, I think, as any across the industry, and particularly strong in the second quarter. We mentioned $1 billion of improvement year-over-year in free cash flow that was bolstered by the strength of our invoicing and collection efforts during the quarter, which puts us in good stead as we think about where we stand year-to-date compared to a year ago. We continue to expect a typical seasonal pattern with the strongest free cash flow and therefore, working capital efficiency in the fourth quarter of the year. But overall, I feel good about our working capital efforts.

Operator

Our next question comes from Peter Arment with Baird.

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

Kathy, thanks for your comments on the mix and kind of the longer-term outlook on where that transitions from cost-plus to kind of fixed-price mix for the company. Is 2023 kind of the peak year? Or is it more like next year for cost-plus? And then just, Dave, related to kind of just your comments on working capital, how do we think about the working capital profile kind of over that similar period? Is that like -- does that become a headwind? Or is it an opportunity for you?

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

Thank you, Peter. I'll start with your mix question. Yes, this is the year to think of as the high watermark for cost-type work given where we are in the development cycle, particularly on many of our largest programs. We mentioned we've been in the 55% of sales range in terms of the cost-plus mix in the first half of the year. We expect that to ease slightly in the second half. But it's really over the next four, five years, we'll see that shift back to the other side of 50-50 and toward that 60-40 fixed-price mix that we described in our prepared remarks. So that is a meaningful opportunity for us in terms of margin expansion as we help deliver those capabilities to our customers in the production phases of the programs.

Working capital longer term, as I mentioned, we're really pleased with our working capital efficiency when we think about where we finished 2022, where we project 2023 finishing as well. And so we don't think of working capital as a source of a lot of upside opportunity for additional efficiency over the next five years, nor do we think of it as an area of expected headwind. I think it will be more neutral than that.

So when you think about what will drive that opportunity to double our current run rate of free cash flow over the next five years, think of it in terms of growth in the sales volume of the business, the margin rate opportunity we've been talking about and the conversion of those margin dollars to cash flow, that's certainly the #1 effort and the #1 driver. But then coincident with that, you'll see a decline in demand for capital expenditures. We're at peak levels in '23 and '24 around capital intensity. That will ease toward more historical levels over the next five years. You'll see some increase in CAS funding over the next couple of years in our -- in the projections we've outlined over the last few quarters. And then cash taxes will decline based on current tax law, particularly related to the amortization requirements for R&D.

Operator

Our next question comes from George Shapiro with Shapiro Research.

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

On the options for the B-21, I mean you still got the same commentary in the Q. I think you've been expecting the first option to get called in the third quarter. Is that the time yet that we'd expect to see some real update on what the losses might be? And if -- would you sit there and just provide a number for that one option and then subsequently wait till other options are exercised? Or what's your thinking as to how you will handle that?

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

George, it's Dave. So as we talked about on the call, the first flight test aircraft successfully powered on in Q2. We remain on track for first flight this year. Again, that timing continues to depend on events and data, of course, over time. And we anticipate that, that first LRIP contract will be awarded following first flight. We will continue to evaluate the performance and the outlook for B-21 LRIP as well as the EMD portion of the program on a quarterly basis and provide updates as we have them. Of course, those will be informed by continued progress in driving efficiencies on the program as well as our understanding of that first LRIP contract lot and beyond. So we'll take all of that into account each quarter as we update our thinking.

We can take that one follow-up. If you don't mind.

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

(inaudible). So about half what you experienced in the first half, can you provide reasons for that slowing?

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

Sure. A few things I'd point out there. Obviously, the growth rate for the year for Space is increased with its guidance update to the low double digits now, and we're really pleased with that. The first half of the year has been closer to that 17% range. Some of what you see there is just a matter of the year-over-year compares where the first two quarters of the year were a bit lighter compares than Q4 in particular.

And that's frankly the case across the business. We had a tremendous Q4 for sales volume in 2022. So we anticipate that the tough compare will lead to a lighter year-over-year growth rate in the second half of the year across all four of our segments as we get to Q4. But overall, the sequential growth is what we'll continue to look for from Space and other sectors. When you look across the company, you've got about 51% of our sales guidance in the second half, 49% in the first half. So you see the demonstration of continued sequential growth and the year-over-year growth rates are more of a matter of those compares.

Operator

Our next question comes from Seth Seifman with JPMorgan.

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

I wanted to ask first about Space. And it seems like -- definitely appreciate the detailed commentary on the overall margin outlook. It seems like Space has been the business where a lot of that margin pressure has been felt most, not just maybe from foreseeable things like mix, but from surprises that have caused the company to guide down the margin there. What is it about the portfolio in Space that's driving that now? And how do you assess the risk from here? Is Space still the sector where there's maybe the most margin risk due to continued work on fixed-price development programs like HALO and maybe exposure to the SDA tranches, which I think are also kind of fixed-price development work. How do you see that now?

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

So overall, the Space business is performing very well. We certainly have pockets in certain programs that we are focused on continuing to improve the discipline around how we're managing those efforts along with the customer. And so I don't see Space as materially different than any other segment of our business in terms of risk profile aside from mix. Certainly, there is more risk in development programs, and that's why we generally have lower margin rates coming out of development. But as Space has transitioned programs to later-stage development and production, their performance is as solid as the rest of the business, and we expect that to continue.

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

Great. And maybe just as a quick follow-up in a perhaps futile attempt to bring out a little bit more information about the NGAD strategy. I believe the collaborative combat aircraft portion of NGAD is a separate solicitation. Are you planning to pursue that?

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

It is a separate solicitation, and we're looking at it closely.

Operator

Our next question comes from Myles Walton with Wolfe Research.

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

Kathy, you mentioned margin expansion in '24, but obviously, the margins for '23 in the guidance has actually come down. So I'm just wondering -- could you put a quantum to the margin expansion you're looking for in '24? Is it to just get back to where prior '23 was? And then maybe for Dave, just a clarification. The 10-Q mentioned a $100 million gain in the third quarter. That isn't in your guidance. I wouldn't imagine just yet. Is that correct?

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

So I'll start and then turn it to Dave. As I think about margin profile, we do expect the second half of this year to be stronger than the first half. And based on our guide, you could expect us to see that progress that we have largely from macroeconomic disruption dissipating through the year to continue into 2024. The mix shift that I spoke of is more gradual. I talked about that shift towards 60% fixed price in 2027. So you could think of that as a progression through 2024 to those later years. And so we're not going to guide today around 2024, we'll provide just some more specifics as the year progresses and certainly at the beginning of the year, next year, but you could think of it as a steady progression of improvement, not a dramatic change from where we've been performing this year.

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

And I could touch on the $100 million gain you referenced, that's just an approximation, of course, until that closes. We do expect that sale of an international minority investment to close in Q3. And that's the item for which we had increased our guidance range by $0.40 last quarter. So that is incorporated into our guidance net -- we see that in that $0.40 range of benefit to the company. So we're pleased to have that approaching and look forward to the cash inflow from it as well.

Operator

Our next question comes from David Strauss from Barclays.

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

Kathy, so your -- the growth rate accelerated a little bit faster in '23 than you had initially anticipated. As we think about '24 with AS returning to growth, and I assume Space growth slowing a little bit. Would you expect top line growth in a similar range? Or is it possible that we could still see an acceleration next year overall for the company as a whole?

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

Right. So we're really pleased with the progress that we've seen this year, our sales guidance increasing at Space and DS, and our other two sectors continuing to see progression toward their growth objectives as well. As we think about this year, a good portion of that growth is the strong backlog that we've developed and continued win of competitive bids.

Part of it, too, though, is what we've been talking about with the phenomenon of having supplier deliveries delayed last year and starting to come in this year, having ramped our headcount significantly in the latter part of last year and early part of this year that's contributing to growth rate. Those elements you wouldn't think of as a continued, it was a bit of a bow wave that we've now seen come into this year. But the growth based on backlog performance and new wins, we do expect to continue into next year and expect to see another year of healthy growth in 2024.

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

And the other point I'd add is, to your point, David, around the segment level view, we do expect the growth to be more balanced going forward with opportunities for growth in each of the four sectors as we demonstrated in this period in Q2. You see the growth in our Defense Systems business having recovered really nicely over the last couple of quarters. There are continued opportunities really across all four of the segments to drive growth.

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

Great. Quick follow-up. On the F-18, how big is that still for you today? And when would you expect that to completely run off?

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

Sure. Consistent with the commentary from our prime on the program, we do anticipate that production will wind down over the next couple of years. And for us, that's 1% or less of sales and, therefore, not too dramatically impactful to the overall company top line. It's incorporated into our thinking about opportunities for growth in sales at AS over the next couple of years as are the other moving pieces we've talked about throughout the call today.

Operator

Our next question comes from Jason Gursky with Citigroup.

Jason Michael Gursky - *Citigroup Inc., Research Division - Research Analyst*

My audio has been a little choppy this morning, so I apologize if you've already commented on this. But the comments you made early in your prepared remarks, Kathy, about the backlog that you had at the end of '21 and where you are going to sit as you exit this year with having delivered about 70% of that backlog. I'm just kind of curious, the remaining 30% that is still in front of you. What -- how big is the B-21 program in the remainder of that 30% that you've got to still deliver on?

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

So the remainder of backlog on B-21 is relatively small because what's in backlog is the EMD program completion. Production has yet to be awarded. So those are the lots we've been talking about. We expect to get the first lot of production on contract later this year. But of course, it is priced. And so that is the contractual commitment, but we have not yet been awarded it, so it's not showing up in backlog.

Programs that are a significant amount of that backlog are programs like Sentinel, a sizable program that was awarded in 2020 or 2021,and is going to carry forward for several more years as part of that EMD program in backlog. And there are several others, but none that rise to that level. But I will remind you the Sentinel program is a cost-plus program.

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

Right. And to that point, among the fixed-price programs where we talked about the 70% of that 2021 backlog having been transitioned into sales by the end of this year. There are no huge individual drivers of the remaining 30%, if you will, and that will gradually translate into sales over the next few years. So a gradual wind down of the remaining 30% based on the metric we described earlier.

Jason Michael Gursky - *Citigroup Inc., Research Division - Research Analyst*

Okay. Right. And then -- I'm sorry to beat a dead horse here on the Space margins. But I did find your comment, Kathy, interesting about the potential for the business to operate above 10%. I think you said you want to drive it to 10%, but there would be opportunities for it potentially to go above that metric at some point in the future.

I'm just kind of curious as to whether that is a comment for the broad portfolio of your Space programs? Because when I historically think of spacecraft and space-based assets, I tend to think of lower margin rates for that kind of work historically because it's been a lot of cost-plus kind of work. So I'm wondering if this is a comment about the broad portfolio and would include assets that are going to be operating up in Space. And is that comment -- if that is true, is it because you've got more fixed-price work going on there than has historically been the case?

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

Yes. So as you think about the transition that the Space market has undergone to where we had few large and exquisite assets. Those were largely developed under cost-plus and then transitioned to production, but in low quantity. Now we're seeing much less dollars go into development and then a transition into production of higher quantity. So that mix will be different in terms of development versus production in the market as a whole.

In addition, when you think about our portfolio and what's in our Space segment, it includes things like solid rocket motors, particularly large solid rocket motors. It includes programs like Sentinel that will transition into production, and programs like Kuiper that we've talked about. So as those transitions happen again specifically now to our portfolio, not just the market in general for Space, we see mix shifts that will be tailwinds to margin over time.

Todd B. Ernst - *Northrop Grumman Corporation - Corporate VP of IR*

And Josh, we have time for one more question.

Operator

And our last question comes from Rob Spingarn with Melius Research.

Robert Michael Spingarn - *Melius Research LLC - MD*

Kathy, just sticking with that a little bit and tying this to the prime versus merchant supplier discussion we had in the beginning on Aeronautics. When you think about the shift, at least in satellites from GEOs to MEOs and LEOs in these highly proliferated constellations. And the significance of SDA in that part of the market and their desire for fixed-price contracts. Is it better, at least in that kind of work to be on the supplier side at some point, would you consider that?

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

We consider it with each opportunity, just as I discussed in our thought process around military aircraft. We don't have a blanket, "we will do this, and we won't do that." We think about each opportunity in terms of its risk profile. The maturity of our designs and offerings at the time that we're being asked to bid also weighs heavily into our thinking about that decision. And so in the case of the Space Development Agency, we are executing on several programs for them today and performing quite well.

So we have chosen wisely and been disciplined in how we have taken on that work, and we'll continue to do that. The beauty of our portfolio, as we've talked about before, is we can choose to prime. But if we don't see the right mix of risk reward, we can also choose to be a supplier and still bring the capability forward that the government needs and expects from us.

Great. Well, I think that's about all we have time for. So thank you to each of you for joining our call today. I also again want to extend my appreciation to the Northrop Grumman team for their continued strong performance and contributions to global security. I hope that all of you enjoy the remainder of your summer, and I look forward to seeing you throughout the summer and talking to you again in October. Take care.

Operator

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

DISCLAIMER

Refinitiv reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Transcripts are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT TRANSCRIPTS IS A TEXTUAL REPRESENTATION OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND WHILE EFFORTS ARE MADE TO PROVIDE AN ACCURATE TRANSCRIPTION, THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES REFINITIV OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT TRANSCRIPT. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.