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Lockheed Martin (LMT)-Pension Update 6/18 Quarter

We discussed LMT's pension funding issues in our April 19, 2018 issue and recommend readers review that for a full understanding of what is happening here and why it should get better after 2018. We explained how three sets of rules have been impacting LMT's pension funding, cash flow, and earnings for years: FAS, CAS, and ERISA. For FAS – think GAAP accounting for pension expense. For CAS – think government reimbursement of pension costs. Since 2014, this has been a sizeable part of LMT's earnings because CAS has exceeded FAS:

$ in mm	2018e	2017	2016	2015	2014	2013	2012
FAS	$1,400	$1,372	$1,019	$1,127	$1,144	$1,948	$1,941
CAS	$2,400	$2,248	$1,921	$1,527	$1,520	$1,466	$1,111
FAS/CAS Spread	$1,050	$876	$902	$400	$376	-482.00	-830.00

The FAS/CAS spread represents income when CAS exceeds FAS and a drag on earnings when FAS is larger. More importantly, CAS represents cash income as it is invoiced and paid by the government. So, earnings have been improving and LMT is paying $5 billion into its pension plan this year. A higher asset total in the pension plans should reduce FAS in future years too. The pension assets are multiplied by the expected rate of return and that produces an offsetting source of income against the expense calculations in computing FAS. In 2019, assuming LMT does not lose money on its pension investments, the $5 billion should reduce FAS by about $375 million. That sets up LMT for a larger FAS/CAS spread in 2019 and more earnings growth. Also, LMT has not increased the discount rate yet – but it may have bottomed out at 3.625% for 2017 and 2018. The company's estimate is a 0.25% change in the discount rate changes pension expense by $115 million. At this point, we would wager that the discount rate is more likely to move up, which would reduce the pension expense further. So, there are two ways to see earnings rise in 2019 and beyond at LMT via the pension plan. That is important because we believe the CAS figure will likely peak in 2019 and remain flat as the transition stage to larger payments shown in the table above is now complete, thus removing a tailwind LMT has enjoyed for several years.

The company's cash flow performance in the first half of 2018 is ahead of forecast and LMT raised guidance for cash from operations by $300 million. This positive is also coming from improved operations – not from growth in FAS/CAS adjustment. We think this is important because 2018 is expected to see a serious cash flow drain due to funding $5 billion into the pension. Net of CAS funding, it was expected to be -$2.6 billion.

$ in mm	2018e	2017	2016	2015	2014	2013	2012
Pension Funding	$5,000	$46	$23	$5	$2,000	$2,250	$3,837
CAS	$2,400	$2,248	$1,921	$1,527	$1,520	$1,466	$1,111
Cash Flow	-$2,600	$2,202	$1,898	$1,522	-$480	-$784	-$2,726

The shortfall in 2018 will be met with cash on hand and borrowing. The dividend coverage will look tighter this year. However, we anticipate the balance sheet will be improving overall and free cash flow will see strong improvement in 2019 and 2020:

$ in mm	2020e	2019e	2018e	2017	2016	2015
Cash from Ops	$7,000	$6,800	$3,300	$6,476	$5,189	$5,101
Capital Spend	$1,200	$1,200	$1,200	$1,177	$1,063	$939
Free Cash Flow	$5,800	$5,600	$2,100	$5,299	$4,126	$4,162
Dividend	$2,773	$2,547	$2,345	$2,163	$2,048	$1,932
Dividend % FCF	48%	45%	112%	41%	50%	46%

This assumes no share repurchases, for the next 2.5 years, which is something the company does frequently. It is assuming an annual increase in the dividend of 20-cents per quarter from the current $2.00 to $2.20 and then $2.40 or basically 10%. Even with that, LMT should be generating about $3 billion in remaining free cash flow after the dividend. From 2015-2017, the company bought back $3 billion, $2 billion, and $2 billion in stock. It is on pace to buy at least $1.0 billion this year. So, it would not be surprising if LMT did retire more stock in 2019 and 2020, which would lower the forecasted dividend payment and improve the payout ratio.

What we think will also make investors more pleased is the debt on the balance sheet should improve with these pension actions. We are going to assume the LMT borrows about $2 billion in short term debt in the second half of 2018 to make the rest of the pension payments. Funded debt is essentially flat since the end of 2017 at $14.3 billion. The pension liability should fall at least $5 billion with the payments this year. Also, the pension liability should also decline if the discount rate increases. LMT estimates that a 25bp move in the discount rate translates to $1.5 billion in change for pension liabilities.

At the end of 2017, LMT had $14.3 billion in debt and $15.7 billion in underfunded pension obligations for $30.0 billion in debt against $7.1 billion in EBITDA or 4.2x. By the end of 2018, debt could be about $16.3 billion and the underfunded pension under $11 billion or $27 billion. If we assume that in 2019 and 2020, the $2.0 billion of borrowing is repaid and LMT sees a 50bp increase in discount rate that cuts the PBO by $3.0 billion more – LMT's balance sheet would likely have under $21 billion in debt or 2.6-2.8x EBITDA and additional pension cash funding needs would likely remain much lighter than in several prior years.

We believe LMT should remain very capable of completing this pension transition and still being very shareholder friendly with a growing dividend that has ample cash flow coverage in the next couple of years. Essentially, the full harmonization of CAS and FAS should allow LMT to avoid repeating the 2010-14 period when pension funding required annual cash funding of $1.0-$2.0 billion as the CAS figure will be higher. And, this should be a company that benefits further from some interest rate increases.

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