

11 November, 2012

Lockheed Martin Corporation



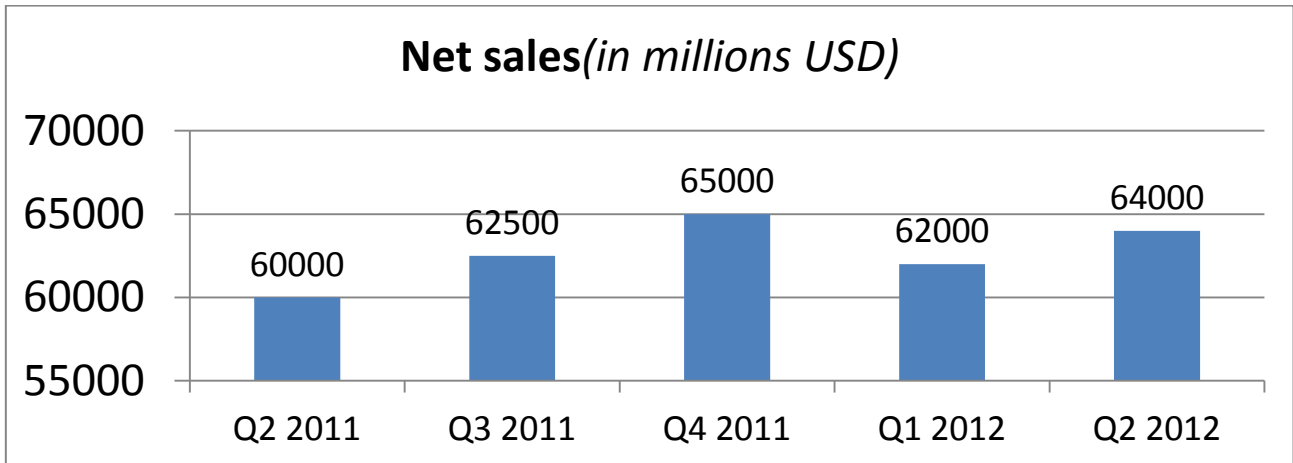
Sector	Aerospace and Defense(A&D)
NYSE	LMT
Current Market Price(CMP)	\$93.37
Target Price	\$156.24
52-week High/Low	\$95.92 / \$72.37
Market Capitalization	\$28,380,000,000
Book Value	\$7.53
P/E	9.63
Equity Shares	2,442,000,000
Recommendation	BUY

THE AEROSPACE AND DEFENSE SECTOR:

The aerospace and defense industry directly employs more than 1 million workers and supports another 2.53 million jobs, as of December 31, 2011.

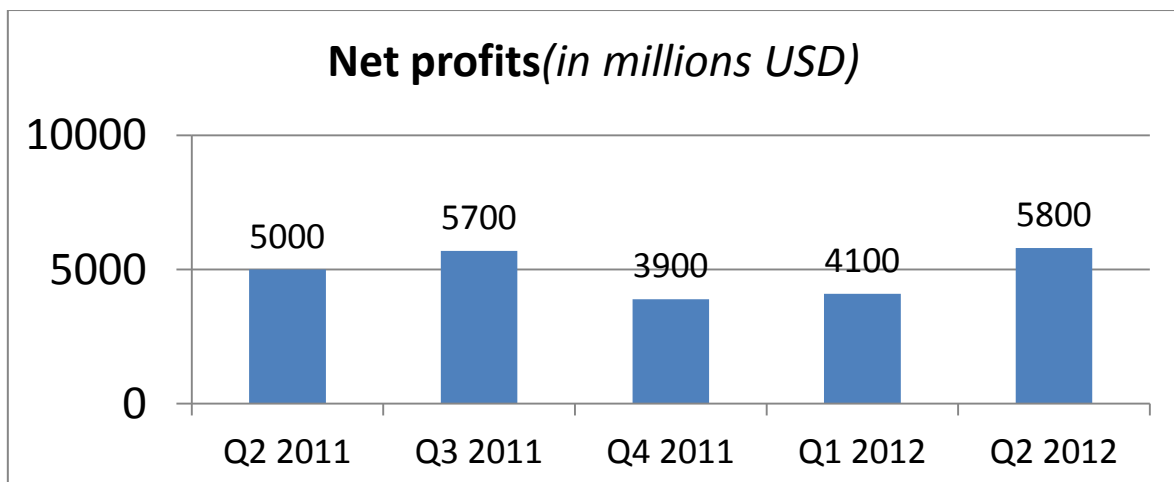
Aerospace and defense sales totalled nearly \$324 billion, which does indicate growth despite the economic downturn faced by the world. Sales of aerospace equipment alone reached \$218 billion in 2011 –the eighth consecutive year of growth.

The Net Sales of Lockheed Martin for the previous 5 quarters is represented by the graph given below:



Source: Annual Reports LMT

Also, net sales for the last 5 quarters are represented by the graph given below:



Source: Annual Reports LMT

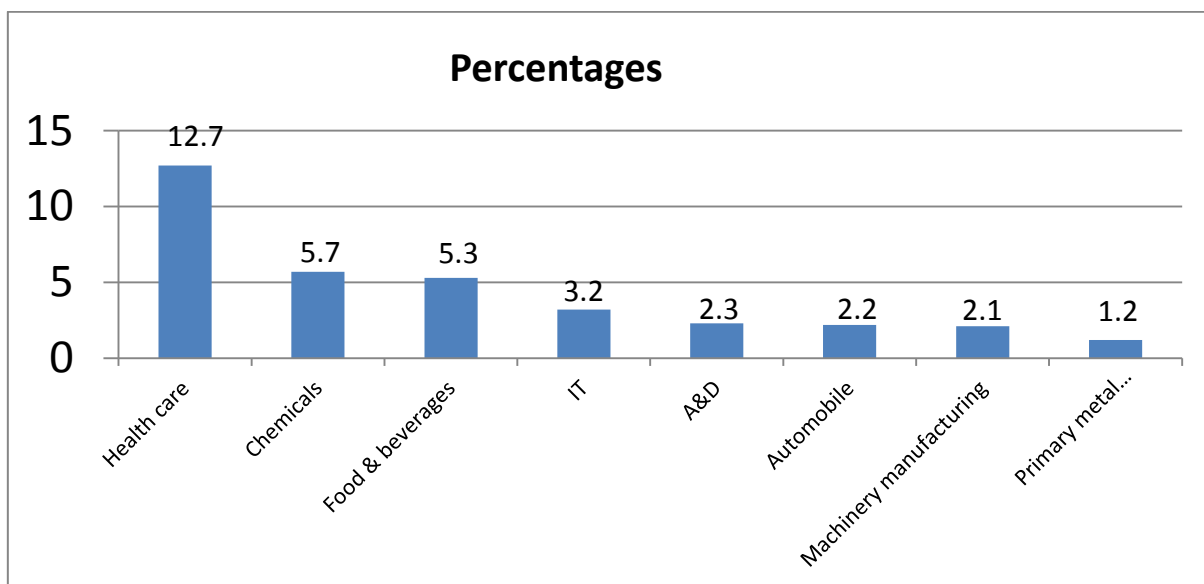
Aerospace and defense exports of \$89.6 billion provide the U.S. economy with a \$42.2 billion foreign trade surplus – the largest of any sector. The imports and exports figures, for some industries of the economy of the U.S. are given in the following table:

Industry	Exports	Imports	Net balance
Chemicals	\$171,526	\$187,754	-\$16,228
Computers and Electronic products	\$120,950	\$324,481	-\$203,532
Aerospace and Defense	\$89,636	\$47,484	\$42,153
Petroleum and coal products	\$60,793	\$102,049	-\$41,256
Agricultural products	\$58,015	\$24,026	\$33,989
Food and kindred products	\$50,901	\$41,025	\$9,876

Source: Deloitte report on A & D industry

The aerospace and defense industry contributes 2.3% to the GDP of the United States. The estimated federal and state employee wage and corporate cash income taxes paid by the aerospace and defense industry and employees totalled \$38 billion. This does not include taxes paid by indirect employees or sales and other taxes.

The contribution of various industries to the Gross Domestic Product for the FY 2011, expressed as a percentage, is represented in the graph below:



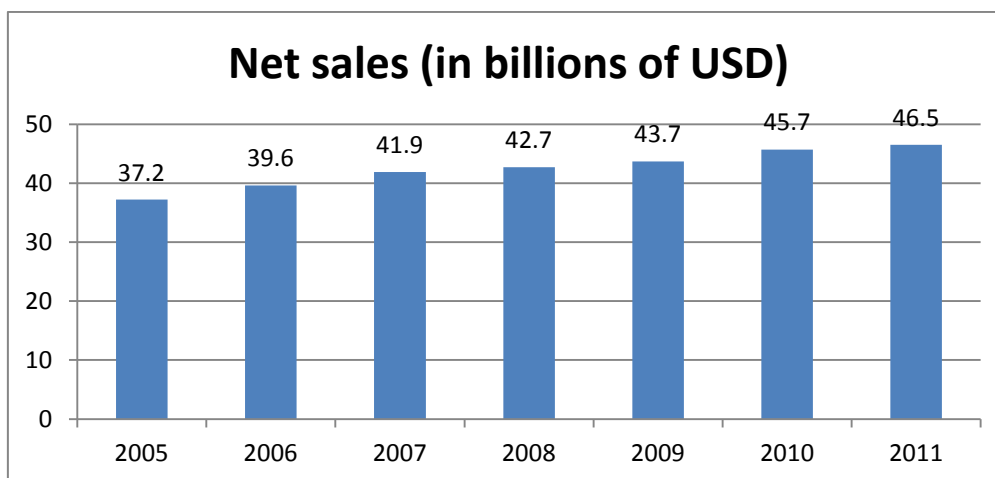
The major contributions of the A&D industry are as follows:

- Reductions in casualties in armed conflict
- Increase in national security
- Safe and efficient air travel
- Increased communications and dissemination of knowledge

- Globalization of supply chain and consumerism
- Scientific research and applied technology advancements

LOCKHEED MARTIN – An Overview:

- Lockheed Martin is a USA-based global security and aerospace company engaged in the research, design, development, manufacture, integration, and sustainment of advanced technology systems and products. It was formed by the merger of Lockheed Corporation and Martin Marietta in March 1995.
- It has its headquarters in Bethesda, Maryland, United States of America, in the Washington Metropolitan Area.
- Lockheed Martin currently employs around 123,000 people across the globe.
- Its current Chairman and CEO is Mr. Robert J.Stevens.
- In 2011, it earned \$46.5 billion in net sales. Its net sales over the last few years is given by the graph below:

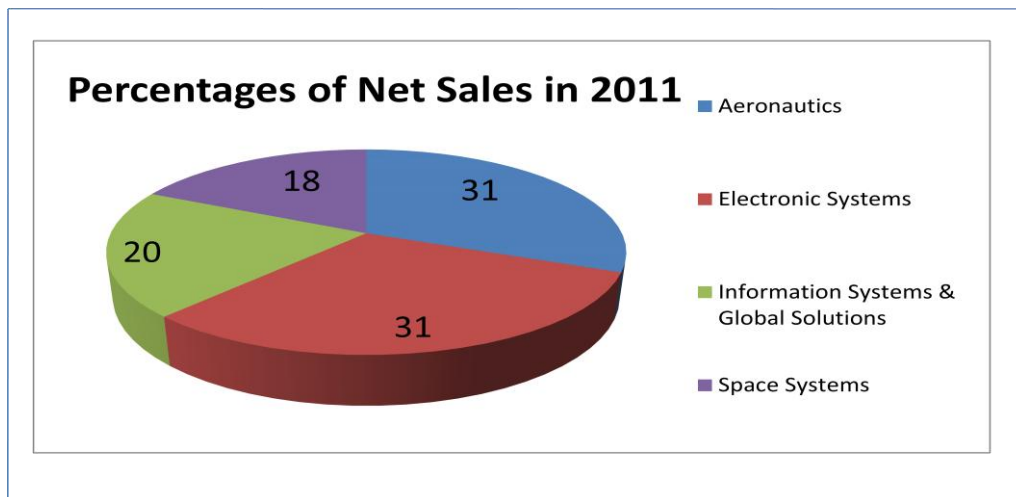


Source: LMT Annual Reports

This graph indicates that there has been an increase in net sales over the last few years. The recession period is characterized by a decrease in the rate of increase of net sales.

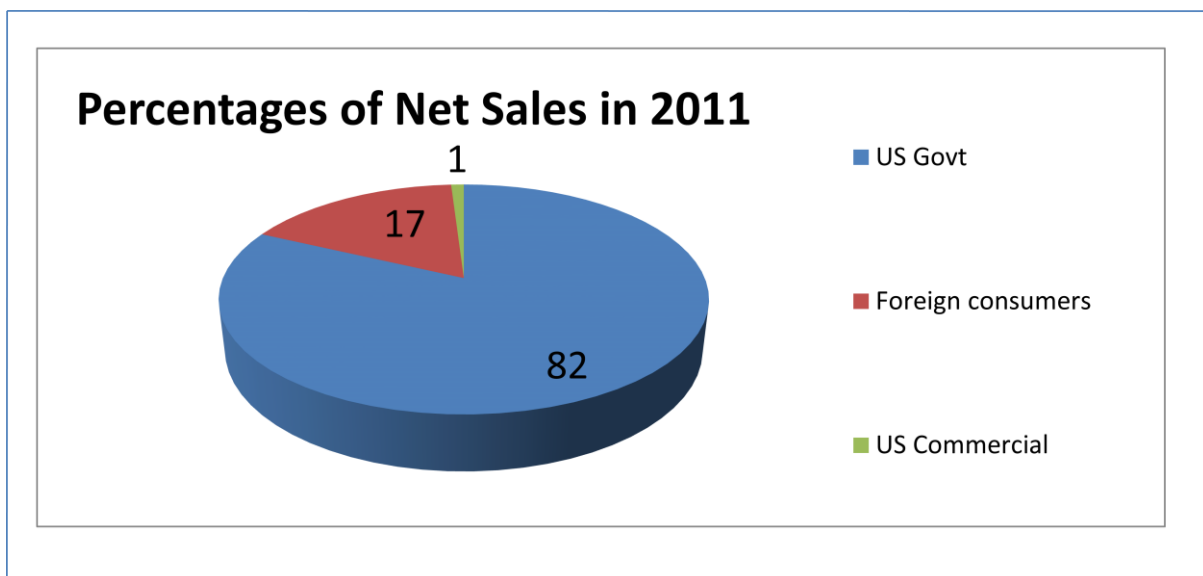
- Lockheed Martin operates in four business segments:
 - Aeronautics
 - Electronic Systems
 - Information systems & Global Solutions
 - Space Systems

The net sales of these different business segments, percentage-wise, are represented by the pie-chart given below:



Source: Annual Report 2011, LMT

Lockheed Martin is one of the world's largest defense contractors: almost 74% of its revenues came from military sales. Lockheed Martin earns money through contracts with the Government of the USA, foreign governments and other commercial contracts. In fact, there is some sort of dependency on the US government, as a substantial portion of its sales are made to it. The percentage of net sales of LMT to different consumers is represented by the graph below:



Source: LMT Annual report, 2011

Lockheed Martin's products are many. Listing these products according to its different business segments:

- **Aerospace and Defense:**

Aircrafts, Ground Vehicles, Missiles and Guided weapons, Missile Defense, Naval systems, Radar systems, Sensors and Situational Awareness, Tactical Communications, Unmanned Systems

- **Information systems & Global Solutions**

Lockheed Martin is a leading partner of the Federal Government of the United States Government, providing 21st century technology solutions. It is presently one of the US government's leading Information Technology providers. Biometrics, Cloud Computing, Cyber Security, Information Management

- **Space**

Climate Monitoring, Satellites, Space Exploration

- **Electronic Systems**

Alternative and Renewable Energy, Energy Management and Storage

LMT- COMPETITORS:

- The principal factors of competition include: value of products and services to the customer; technical and management capability; the ability to develop and implement complex, integrated system architectures; release of technology; ability to execute and perform against contract requirements; and ability to provide timely solutions.
- Its major competitors include: The Boeing Company (BA) , Northrop Grumman Corporation(NOC), Raytheon Co(RTN), and L-3 Communication Holdings(LLL).
- Some areas of comparison have been depicted in the following table:

Ratio \ Ticker	LMT	BA	LLL	NOC	RTN	IND
Market Cap	28.38B	54.76B	7.08B	16.13B	18.71B	851.49M
Revenue	47.17B	73.21B	15.16B	25.88B	24.74B	1.44B
Gross Margin	8%	18%	11%	22%	21%	28%
Oper. Margin	8%	8%	11%	13%	12%	10%
P/E	10.60	12.71	7.88	8.31	10.10	14.38
P/S	0.60	0.75	0.45	0.62	0.76	0.87
PEG Ratio	1.49	1.12	2.12	1.65	1.17	1.10
Div Yield	4.58%	2.41%	2.75%	3.43%	3.56%	N/A

Source: yahoo finance

NOTE: All figures in the above table are for the financial year 2011.

LMT- SWOT ANALYSIS:

➤ **STRENGTHS:**

- National and Global operations.

LMT has over 1,000 facilities in 500 cities and 46 states throughout the U.S.. Internationally, business locations in 75 nations and territories

- LMT's Strong/Diverse product portfolio

It has a very diverse product portfolio—in aeronautics(including tactical aircraft, airlift, etc.), electronic systems(including missiles, naval systems, etc),Information systems and Global solutions(including federal services), space systems(including space launch , commercial satellites, etc.), among others.

- Customer base stability

The majority of LMT's business is with the U.S. Department of Defense and the U.S. federal government agencies. They are the largest provider of IT services, systems integration, and training to the U.S. Government.

- Barriers to entry

Barriers to entry established by the government limits the amount of competition within a segment. Limited competition increases prices and margins for companies that are already in the industry. Seeking governmental approval could be a time consuming process.

➤ **WEAKNESSES:**

- Low Price Approach

Cost control increases profits, which increases the stock price of companies. This can be achieved through lower employee salaries and high employee turnover.

- Concentrated Buyers

A low concentration of buyers limits the ability LMT to increase their prices and margins by seeking the highest bidder for their product.

- Governmental Contracts

Government contracts are large and highly volatile. Since defense spending is politically driven and often changes quickly, companies cannot make the necessary long term planning required to efficiently build a business. This increases risk to the companies and decreases their potential value.

➤ **OPPORTUNITIES:**

- Terrorism Risk

Continued terrorism risk will bring additional benefits to aerospace and defense stocks. Security-related stocks will also benefit as the private sector invests in security.

- Accelerating US military and space market
- Lockheed Martin's diversification into cyber-security and Healthcare Information Technology
- Acquisition, Merger and Strategic Alliance
- Globalization

As the expansion of western economies slows in relation to the rest of the world, opportunities for growth will exist outside the borders of the home countries.

➤ **THREATS:**

- Isolationist mentality due to prolonged wars.
- After-effects of the global recession
- Austerity drive:

The big spenders are gradually lowering their defense budgets and concentrating on other avenues to fix their ailing economies. Another cause for concern is that Barack Obama has just won the Presidential Election, and has been re-elected as President for the duration 2012-2017. One of his pre-poll promises was a cut in the defense budget. This is a huge threat for the Aerospace and Defense Sector as a whole, and Lockheed Martin, in particular.

- Volatile commodity prices.
- Long-Term and Specific Program Cuts:

The amount allocated for US wars abroad would also witness a sharp fall mainly owing to troop withdrawal from Iraq and a drawdown in Afghanistan.

- Intense Competition
- Government Regulation

LMT- PORTER'S FIVE FORCES:

➤ **Competition from substitutes:** LOW

Generally, contracts take long periods of time to complete. Due to this, it is hard for the government to switch suppliers over a short period of time, providing some protection for Lockheed Martin from substitutes. Lockheed Martin's products are patent protected which prevents the government from switching suppliers and expecting the same product. There are few competitors in the industry leaving few quality substitutes.

➤ **Rivalry between established competitors:** HIGH

LMT only has a few competitors, all of which are of similar size. Unfortunately, the industry itself is close to maturing and expansive growth is hard to achieve. This implies that there is very strong competition as these companies will grow only by taking market share away from its competitors, rather than targeting new consumers. Rivalry also intensifies while competitors are involved in bidding on or are competing for a new project.

➤ **Threat of Entry:** LOW

- Fixed costs are high, but since the United States government is really the only customer, it is incredibly difficult to establish a new company and take business away from others that exhibit a proven track record.
- While many novel ideas are still generated in small, research-oriented aerospace/defense firms, the actual production and testing of products and services can only be conducted with companies whose budgets support such actions.

➤ **Bargaining power of buyers:** HIGH

The United States Government accounts for almost 85% of Lockheed Martin's revenue, posing a massive risk if budget cuts materialize. The US government can decide what products need to be built, when they need to be completed, and how many need to be produced. It also decides where the products can be sold, when they can be released, and how many can be sold internationally.

➤ **Bargaining power of sellers:** LOW

Many contracts are assigned a cost plus structure. The reason for this contract type is the government's hesitance to use low quality inputs for high quality products. This structure helps counteract the effect of pass-through costs from suppliers for raw materials.

LMT- IMPACT OF RECESSION:

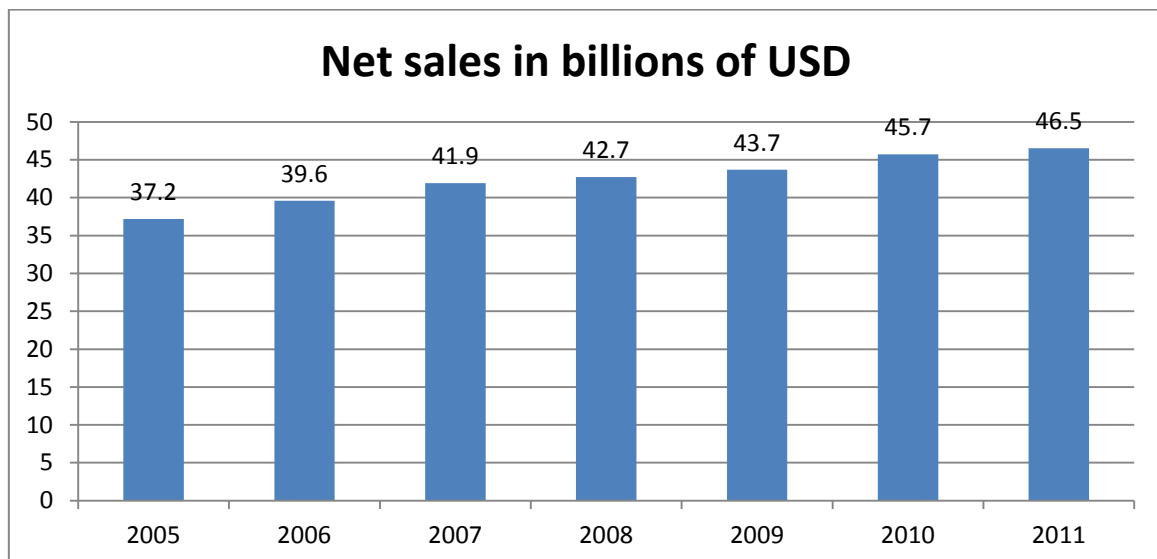
The global recession of 2008-2012 affected the entire world economy. It was characterized by various systemic imbalances and had its root in the U.S. sub-prime mortgage crisis.

The Aerospace and Defense industry was severely hit by the recession. The table given below gives a comparative analysis of revenue growth over the years 2006-2010 of selected industries. This table clearly shows that this industry did not do too well as compared to the other U.S. industries.

Industry	2006	2007	2008	2009	2010
Metals and mining	13.2%	3.6%	7.7%	-34.8%	29.9%
Chemicals	7.2%	6.0%	3.1%	-23.4%	18.2%
Machinery	10.6%	12.2%	16.1%	-25.8%	16.8%
Information technology	7.8%	7.7%	2.5%	-8.3%	16.1%
Auto and components	-2.4%	-1.1%	-12.4%	-31.9%	14.6%
Health care	8.4%	3.5%	7.3%	2.8%	6.0%
Aerospace and defense	6.4%	21.4%	7.1%	-2.6%	1.9%
Total average ³⁶	7.6%	5.8%	1.0%	-10.5%	9.4%

Source: Deloitte report on A&D industry

Lockheed Martin, in particular, showed a percentage-wise reduction in increase in net sales. This can be observed in the graph given below.



Source: LMT Annual Reports

The above graphs indicate that though there was a reduction in the increase in net sales of Lockheed Martin, it still did better than the Aerospace and Defense industry.

Another indication of the performance of Lockheed Martin during the recession period, though not entirely a good one by itself, is observing the trends in the share prices. This has been depicted by the graph given below:



Source: google finance

WALL STREET'S EXPECTATIONS FROM LMT:

- Despite a shortfall at its training-simulation division, LMT's revenue and profit rose in the second quarter of 2012, despite analysts' forecast.
- Lockheed Martin's earnings in the second quarter of 2012 went up 5% to \$2.38 a share. It also raised its estimate of profit for the year 2012 to \$4.025-4.125 billion slightly from the earlier \$3.9-4.0 billion. Thus Lockheed Martin did better than expected.

Yearly Earnings Forecasts

Fiscal Year End	Consensus EPS* Forecast	High EPS* Forecast	Low EPS* Forecast
Dec 2012	8.1	8.3	7.96
Dec 2013	8.38	8.85	7.6
Dec 2014	9.21	10.68	7.6

Quarterly Earnings Forecasts

Fiscal Quarter End	Consensus EPS* Forecast	High EPS* Forecast	Low EPS* Forecast
Sep 2012	1.85	1.95	1.77
Dec 2012	1.85	2	1.7
Mar 2013	1.94	2.08	1.85
Jun 2013	2.22	2.36	2.1

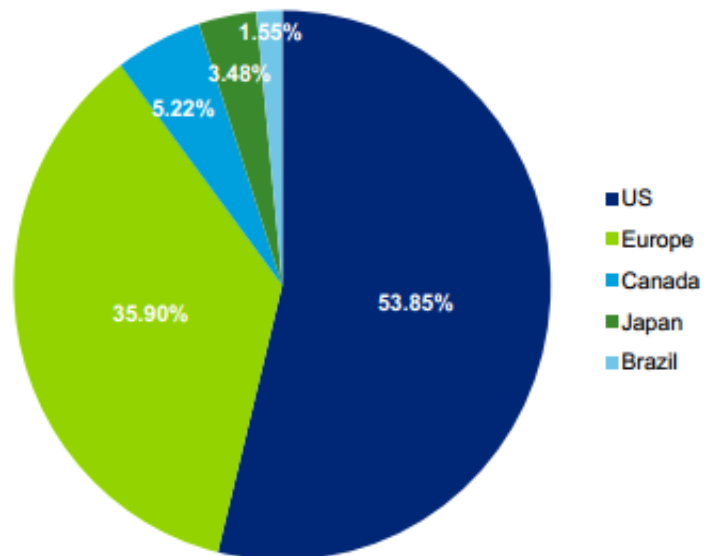
Source: www.nasdaq.com

FUTURE AHEAD:

- The Defense Department of the United States Government is shifting into new areas of warfare, but the companies of this industry, are not sure how to reposition to succeed in non-traditional markets.

- There is a growing opinion among nations that prevention of conflict, inter-agency work, stabilization and policing are much more important than actually participating in wars. The companies that will thrive are those with the non-kinetic technology and skills that can help the military succeed in the outer edges.
- The Aerospace and Defense industry will be largely affected by the outcome of the Presidential Elections of USA, 2012. A point of contention between the 2 candidates was the Defense budget. The future performance of LMT depends on whether President Barack Obama, on being re-elected will renege on his promise or whether he will implement his proposed defense cuts.
- Those that wish to compete in today's climate must focus on improving affordability and maintaining cost fitness while establishing long-range plans grounded in the grim realities of the next five to 10 years of reduced demand.
- Defense companies may need to shift from a central operating model to a portfolio management model that allows individual business units to adapt to the unique requirements of their markets.
- There are various macroeconomic factors that have an impact on Lockheed Martin, like growing pressure on defense budgets, a difficult financial environment, and growing competition from firms in other countries.

Distribution of A&D revenues by country/region



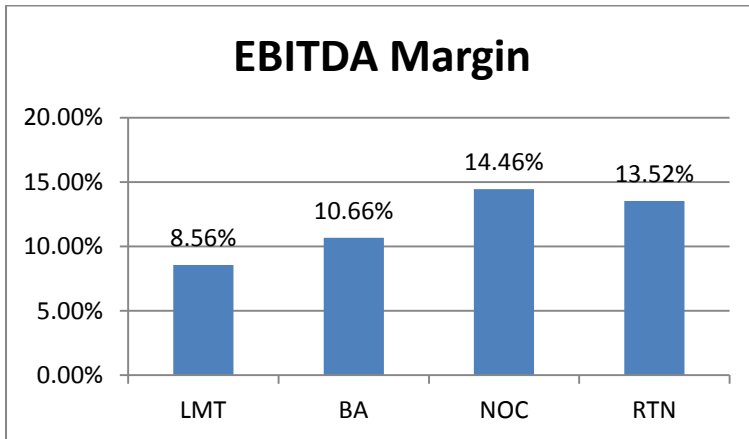
The new market realities will require risk taking and bold moves to continue growth in revenues and profitability.

Emerging areas are : cyber security, intelligence, surveillance and reconnaissance, defense electronics, precision targeting and response, etc.

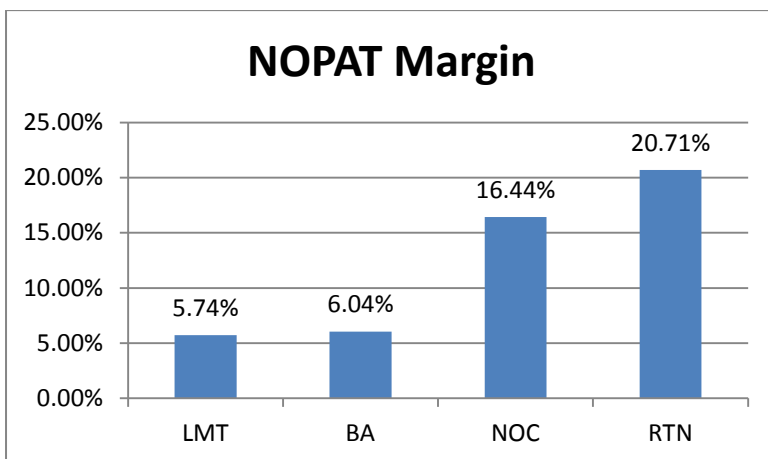
- New paradigms in human spaceflight are evolving. Development of new, commercially developed systems for astronaut transportation to the International Space Station. Meanwhile, the US security space sector is currently recapitalizing major satellite systems after years of development work. In light of reduced security budgets, the challenge is to ensure the health of the industrial base so that irreplaceable skills and capabilities are not lost.
- Potential budget cuts has led to measures like cost cutting, layoffs, and outsourcing, principally for defense contractors, to recruiting, rehiring, training and other job creation actions. In fact, Lockheed Martin has cut

around 8100 jobs in the years 2010 and 2011. However, these job cuts were offset by selected hiring in the industry as well.

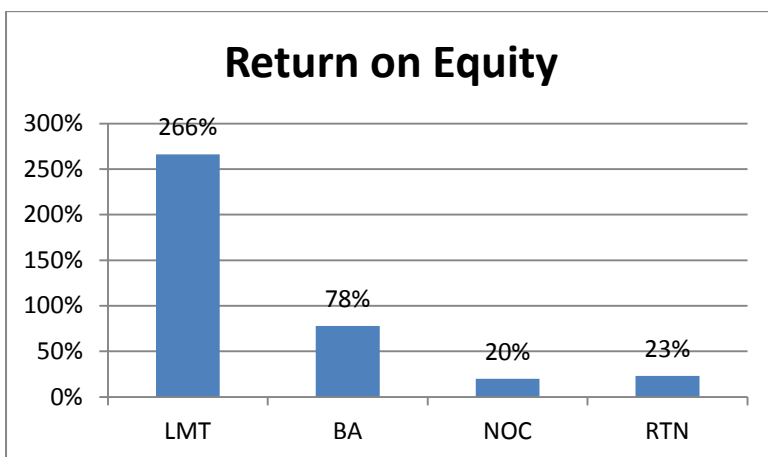
COMPARATIVE FINANCIAL RATIO ANALYSIS for FY-2011:



EBITDA margin is defined as EBITDA/Net Sales. Smaller the COGS value, higher the EBITDA margin. So higher the EBITDA margin, better the position of the company. The value of EBITDA margin of LMT is lesser than the industry average

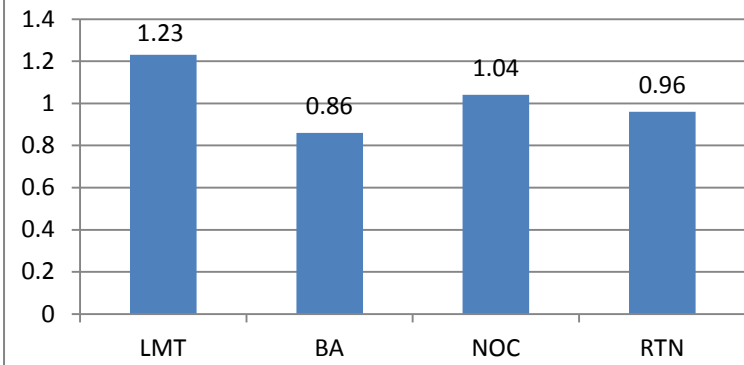


NOPAT is Net Operating Profit after Profit. So, NOPAT margin is $EBIT \cdot (1 - T_x) / \text{Net sales}$. The graph is an indication that LMT is doing very badly compared to peers.



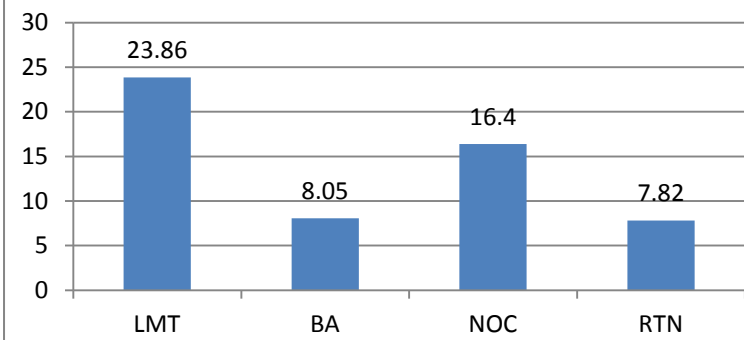
ROE is Net Profit/Shareholder's equity. The very high value of ROE for Lockheed Martin is an indication of excessive leverage taken on by Lockheed Martin.

Asset Turnover



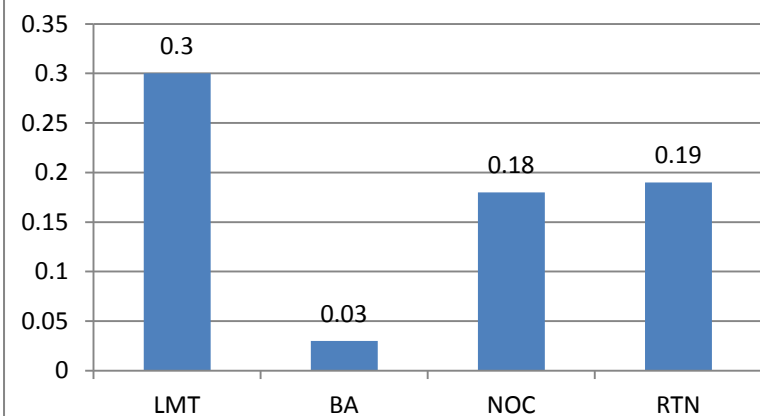
Asset Turnover is defined as $\text{Net Sales} / \text{Total assets}$. The graph indicates that Lockheed Martin is doing comparatively well, with its assets not showing any depreciation.

Operating working capital turnover



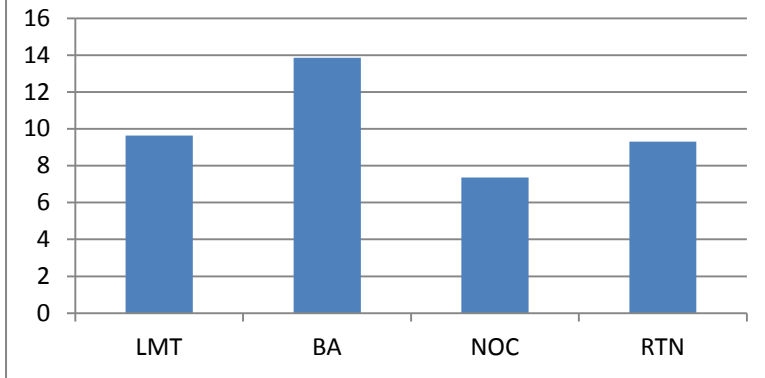
It is defined as $\text{Net Sales} / \text{Average operating working capital}$. This graph indicates that Lockheed Martin is more effective than its peers in converting working capital into net sales.

Cash ratio



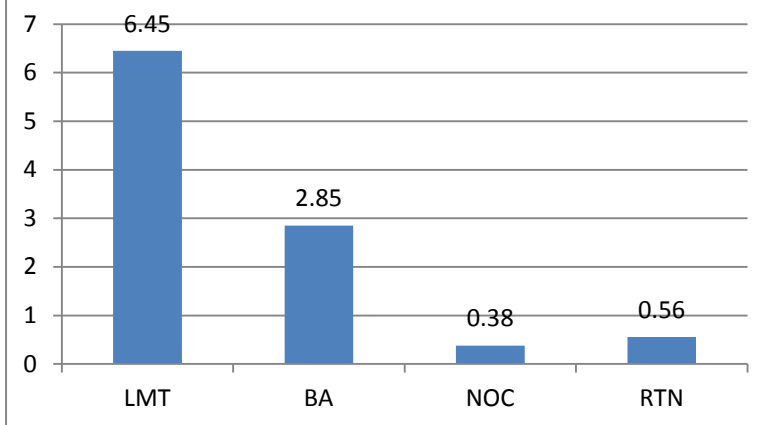
It is defined as $\text{cash and cash equivalents} / \text{current liabilities}$. It is obvious from the graph that the entire industry is doing badly; as the cash and cash equivalents cannot cover their current liabilities. Compared to its peers, Lockheed Martin is relatively better off, but it still is in an unenviable position.

P/E ratio



It is defined as Share Price/Earnings per share. The graph is indicative of the fact that LMT, RTN and NOC have reached a certain maturity stage with respect to BA.

Debt-to-Equity ratio



The graph indicates that Lockheed Martin is over-leveraged compared to its peers. It also reflects the fact that Lockheed Martin prefers to raise money by debt than through equity.

NOTE: In the section on Comparative Financial Ratio Analysis, the following acronyms are used judiciously:

- LMT* : *Lockheed Martin*
- BA* : *The Boeing Company*
- NOC* : *Northrop Grumman Corporation*
- RTN* : *Raytheon Corporation*

VALUATION OF THE STOCK:

The stock of Lockheed Martin can be correctly valued using a Free Cash Flow from the Firm (FCFF) model and a Free Cash Flow to Equity (FCFE) model. On applying these models, the intrinsic value of the stock of Lockheed Martin is \$156.24 per share. Also, there is a huge difference between the value of the firm using FCFF and FCFE models. This quantitative difference represents the present value of total debt of LMT. This is further indication of the fact that LMT is heavily in debt: analysing along with the facts that weight of debt has been calculated as 0.8.

RECOMMENDATION TO BUY

As the Current Market Price (CMP) of the Equity is less than the INTRINSIC value; a BUY is recommended on the stock. One important analysis to be made is that the Aerospace and Defense industry is expected to face a downturn as its major consumer, i.e. the federal US government, is expected to cut down its sales over the next few years – due to the policies of the Obama administration. Also the company is well settled in its operations, i.e. it has attained a certain maturity stage. The company cannot be expected to grow such that the intrinsic value rises considerably. Consequently though a BUY is recommended; the investor is at the same time advised to keep a close eye on the stock movement once it crosses the above mentioned intrinsic value of \$156.24.

DISCLAIMER:

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