
CAPITOL ANALYSTS NETWORK, INC.

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POST SHUTDOWN: SEQUESTER REBOUND FOR DEFENSE

It can pay to think ahead. After the Congressional impasse over using the annual appropriations process to defund or amend Obamacare ends, and the government reopens, Congressional debate over the proper level of fiscal year 2014 "discretionary" federal spending will break out in the open. This conversation is pivotal to the performance of at least 22 major publicly-traded companies, primarily defense contractors. CAN recommends investors add to their positions in these companies now because we foresee that the debate will conclude with FY 2014 defense appropriations being higher than the market expects.

Right now, it does not appear that way. Several "Continuing Resolutions" (CRs) the House has sent over to the Senate these last few weeks all freeze FY 2013 discretionary spending totals at \$988 billion. This provides \$486 billion for baseline national defense, which excludes Afghanistan and other anti-terror funding, through December 15, 2013 -- maintaining tens of billions in defense sequester cuts resulting from the 2011 Budget Control Agreement. Obscured by the noisy battle over defunding Obamacare, the Senate has passed its own Continuing Resolution, also freezing overall discretionary spending and defense spending at the House CR level. But \$486 billion is not likely to be the amount provided by Congress in FY 2014 for national defense when the final levels of discretionary spending are established later in the process. Last April, the Obama Administration submitted a FY 2014 budget, requesting \$516 billion in defense spending. Meanwhile, the House GOP determined \$513 billion as the appropriate level when adopting the First Concurrent Budget Resolution on March 21, 2013.

Figures are in millions of dollars of discretionary budget authority

	Fiscal 2013 Enacted Appropriations	Fiscal 2013 Spending Levels (post- sequester)	Fiscal 2014 President's Request	Fiscal 2014 House Allocations (as revised)	Fiscal 2014 Senate Allocations
Agriculture	\$20,510	\$19,560	\$19,667	\$19,450	\$20,930
Commerce-Justice-Science	50,110	47,020	52,014	47,396	52,272
Defense	517,468	486,297	515,910	512,522	516,624
Energy-Water	36,735	34,263	34,483	30,426	34,773
Financial Service	21,415	19,874	23,756	16,966	23,031
Homeland Security	39,594	37,759	39,030	38,991	39,100
Interior-Environment	29,767	28,240	29,973	24,278	30,100
Labor-HHS-Education	156,556	149,640	165,802	121,797	164,330
Legislative Branch	4,277	4,061	4,507	4,124	4,350
Military Construction-VA	71,903	70,909	74,691	73,320	74,366
State-Foreign Operations	42,079	40,358	47,872	34,103	44,079
Transportation-HUD	51,698	48,411	51,605	44,100	54,045
Total	\$1,042,112	\$986,422	\$1,059,310	\$967,473	\$1,058,000

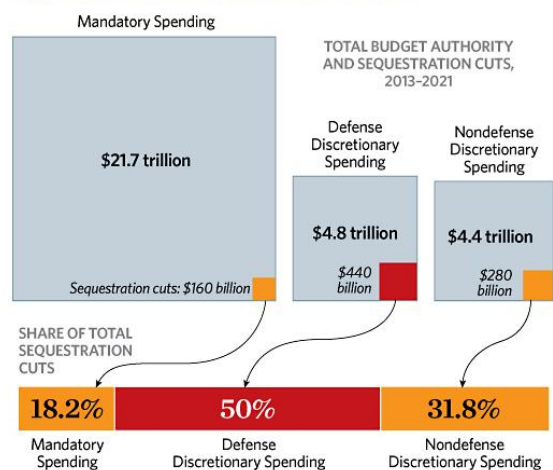
Source: Congressional Quarterly/Roll Call

Annualizing the short-term House and Senate CR levels for defense spending generates a pessimistic projection for what contractors can expect next year. The final level is likely to be higher than these post-sequester levels.

Sequester: Every Defense Spender's Enemy

When the 2011 Congressional Supercommittee failed to reach agreement on entitlement-centered fiscal reforms to address the country's long-term budget deficit, sequestration -- \$1.2

Sequestration Cuts Hit Defense Hardest



Source: Congressional Budget Office, *Updated Budget Projections: Fiscal Years 2013 to 2023*, May 2013, <http://www.cbo.gov/publication/44172> (accessed May 15, 2013).

Federal Spending by the Numbers 2013 heritage.org

increase of \$15 billion in guns with an approximate \$15 billion increase in butter. This would "split-the-difference" in the budget authority chart.

Key Officials Want Relief from the Sequester

Pressure for undoing the defense sequester is not just coming from the usual suspects: GOP defense hawks. It also is coming from the Obama Administration, the nation's top professional soldiers, and from influential congressional Democrats.

Defense Secretary Chuck Hagel, for example, laments the impact of the sequester on national security. Complying with the current law he abhors but must implement, he plans reductions in the sizes of both the uniformed and civilian bureaucracies and shrinking pay and benefit increases. He is readying cuts in operational costs by reducing patrols and training. He also plans to stretch out the procurement schedule for weapons systems to reduce yearly expenditures. During a recent hearing before the House Armed Services Committee, the Army, Navy, and Air Force Secretaries detailed the impact of the sequester on the Defense Department's equipment modernization plans. They are not pleased, and two weeks ago they gave the House Armed Services Committee an earful ([military services chiefs](#)).

At the end of the process, the full impact of the sequester is unlikely to hit, however, given the sentiment of senior congressional Democrats who, like President Obama, support

spending more on defense. The Assistant Democratic Majority Leader Dick Durbin (D-IL), the second ranking Senate Democrat, and the Chairman of the Appropriations Subcommittee on Defense said this, referring to military sequestration cuts, "We cannot continue like this." ([Senator Durbin](#)) Or, consider the views of Congressman Adam Smith (D-WA), the ranking Democrat on the House Armed Services Committee, who said last month: "Personally, I would end sequestration tomorrow. You know, we can talk about how to get the budget deficit under control long term, revenues and spending and all of that, but the one thing we know is that sequestration is really devastating our military."

Who are the Likely Winners?

Listed below are 22 publicly-traded companies that generate 26 percent to 100 percent of their revenues from defense work. They are involved in research and development and procurement of major weapons systems, including submarines, jet fighters, and anti-missile systems. They also supply spare parts to the weapons systems they sold previously. If Congress provides an added \$15 billion to defense in FY 2014, they will receive the bulk of it.

Company	Ticker	Federal Revenue (\$Millions)	Total Revenue	Government Revenue as a % of Total Revenue
EMERGENT BIOSOLUTIONS INC.	EBS	\$399.28	\$281.89	142%
HUNTINGTON INGALLS INDUSTRIES INC.	HII	\$7,407.22	\$6,708.00	110%
ITT CORPORATION	ITT	\$2,310.44	\$2,227.80	104%
LOCKHEED MARTIN CORPORATION	LMT	\$36,961.76	\$47,182.00	78%
BABCOCK & WILCOX COMPANY THE	BWC	\$2,475.36	\$3,291.36	75%
MANTECH INTERNATIONAL CORPORATION	MANT	\$1,932.60	\$2,582.30	75%
BOOZ ALLEN HAMILTON HOLDING CORPORATION	BAH	\$4,023.54	\$5,758.06	70%
SAIC INC.	SAI	\$7,406.71	\$11,173.00	66%
CACI INTERNATIONAL INC	CACI	\$2,359.15	\$3,681.99	64%
RAYTHEON COMPANY	RTN	\$15,053.75	\$24,400.00	62%
L-3 COMMUNICATIONS HOLDINGS INC.	LLL	\$7,009.07	\$13,146.00	53%
GENERAL DYNAMICS CORPORATION	GD	\$14,956.50	\$31,513.00	47%
ORBITAL SCIENCES CORPORATION	ORB	\$679.14	\$1,436.77	47%
HARRIS CORPORATION	HRS	\$2,256.85	\$5,111.70	44%
NORTHROP GRUMMAN CORPORATION	NOC	\$10,374.63	\$25,218.00	41%
ALLIANT TECHSYSTEMS INC.	ATK	\$1,781.21	\$4,362.15	41%
URS CORPORATION	URS	\$4,352.56	\$10,972.50	40%
THE BOEING COMPANY	BA	\$29,440.81	\$81,698.00	36%
CUBIC CORPORATION	CCC	\$450.97	\$1,381.50	33%
HEALTH NET INC.	HNT	\$3,141.80	\$11,289.09	28%
TETRA TECH INC.	TTEK	\$729.55	\$2,711.08	27%
COMPUTER SCIENCES CORPORATION	CSC	\$3,840.48	\$14,993.00	26%

Sources: General Services Administration <https://www.fpsds.gov/fpsdsng/index.php/reports>, Company 10-K Reports

Clearly, the securities of Huntington Ingalls, ITT, and Lockheed Martin will respond more to the news that defense spending is going up than Tetra Tech or Computer Sciences, but a

rising tide of defense funding helps all military contractors. The top 100 defense contractors received \$228 billion in 2012 ([GSA](#)). If you are interested in specific weapons procurements that are affected by overall defense funding levels, please review this document from the [Chief Financial Officer](#) for the Defense Department.

Overall, the defense industry could see a 6 percent increase in top line revenues if defense spending rises by \$15 billion, boosting profits for the most exposed contractors by 6 to 10 percent. If you look deep enough, not all the budget news from Washington is bad for investors.

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