THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

HII - Huntington Ingalls Industries Inc at Sanford C Bernstein Strategic Decision Conference

EVENT DATE/TIME: MAY 31, 2017 / 8:00PM GMT

CORPORATE PARTICIPANTS

C. Michael Petters *Huntington Ingalls Industries, Inc. - CEO, President and Director*

CONFERENCE CALL PARTICIPANTS

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

PRESENTATION

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

Okay. Why don't we get started? I'm Doug Harned, Bernstein's Aerospace and Defense analyst. I'm very happy to have with us, again, Mike Petters, the President and CEO of Huntington Ingalls. As you have questions, it's as you've seen it before, please pass the cards and someone will bring those up to me. First thing, Mike wants to say a couple of words and then we'll get started.

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Here we go. So I'm going to start by saying the traditional safe harbor provisions that you hear all the time remain in effect. These are forward-looking statements that we might talk about today, and they are covered by all the provisions that we normally cover those provisions with. So I hope that everybody understands that. And we'll go from there. Do you want to start, Doug, and...

QUESTIONS AND ANSWERS

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

Okay, great. Well, I'm -- like -- I think, I'm going to start out by asking you a question you've probably heard a lot of times. And that is, when you think about the new 2018 budget, the discussion around moving to a 355-ship Navy, at Huntington Ingalls, how do you look at that?

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Yes, so we're -- we believe that the demand signal for the Navy to be bigger is real. That -- from the things that we can see, the Navy activity is higher, the employments are longer and the ships are being worked a lot harder. And so there's a need for the Navy to be bigger to keep doing all the things they're being asked to do. So I think that, that part of the recognition is good. We have said for many years now, Doug, that you've been with us -- been covering us, we've pointed out that sequestration is bad law, and that it needs to be repealed. And we've said that from our industry standpoint, we have an industry issue with how do you pay for the Columbia class strategic recapitalization? If you don't find a way to pay for that separately from the way you buy your Navy, you're going to wreck the Navy trying to pay for Columbia. We've been saying that for years. I think what's happened over the past year is, a lot of people now recognize that the Navy needs to be bigger to do all the things that we ask it to do. But we still don't have a change to sequestration, and we still don't really have a sorting out of how Columbia class is going to get paid for. And so as a result, while the 2017 budget was pretty strong and pretty good budget, 2018 budget is pretty constrained, and I think it's being constrained not by intent, we -- this is an indication that we don't intend to make the Navy bigger. I think, it's really constrained by the structure that we have to create a budget that sits in there and fits in with BCA, and we have a strategic recap challenge. So that's kind of the way we're looking at it. We think intent is good. We think that understanding of the problem is good. We think that the budget piece of it still, as we've been saying for years, has to be fixed.

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

Well, when you look at the '17 budget and there was some money carved out for Columbia class there. When you go to the '18 budget, the ship count, when you count the port ships is actually even lower than what has been proposed under the Obama administration, and it's -- major ships are all the same. Now was that surprising to you to not see a move to at least attempt to add a couple more ships?

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Well, I mean, I'll go back to what I said. I mean, your -- first of all, the comparison to the '17 budget that was approved in April to the '18 budget submission that came in May, I mean, '18 budget's got a long ways to go before you actually are in the same place that the '17 budget was in April, right? There's a long process. The legislative piece of it and all that sort of thing. But I still think that the constraints are there, and so I think what the -- I think what you see in the budget is, here's the best we can do under the constraints that we have.

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

When you look ahead, and I think -- I would venture that most people in the Pentagon see this the same way. I think you have bipartisan support for more ships. We're not seeing it in the budgets as they go through because of these constraints. From an investment standpoint, in Huntington Ingalls, when can you become comfortable that you think this is going to move upwards and any investments you need to make in preparation for that makes sense? When can it be justified?

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Sure. Yes, I think -- I mean, there's signals you can send now that don't require major moves in the budget today. You could decide to just begin -- you could begin the process of ramping up production of submarines. I mean, there is a talk of putting another submarine in 2021, right, the same year you're going to buy the first Columbia class. There's a question of do you ramp up after that to something 2.5 or 3 a year, are you going to go do that? You can start sending the signals that you're going to do that. And the Congress could actually start indicating that through authorizations in either long lead material or contracting authorities or -- there's lot of ways that they could send signals that they have -- they're committed to go and do this. In my opinion, the #1 way they could do that is to decide that in the '18 budget, the Navy is actually pointing out that this is the year that you buy the CVN-80, the Enterprise. That we have a contract on the front-end of Enterprise. We're already working on the ship a little bit, but this is the big year for procurement of that ship. Well, we have a history of having bought these ships 2 at a time in the past, or even 3. And -- we haven't bought them 3 at a time, but if the Congress were to authorize the Navy to buy 2 carriers, allow them to come and contract with us for 2 carriers, allow us to go to the supply chain and pulse the supply chain for 2 aircraft carriers, that would be a huge signal to the whole industry that we're really serious about changing the size of the Navy, and we need everyone to begin investing into that to make it happen. And you can do that -- our view is that you can do that whether you have BCA in place or not, you can send that signal and begin the process.

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

I mean, recently, you've had trouble even buying a carrier one at a time. I mean, these things can be incremental...

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Well, okay. I mean, it's a fair question, but the last carrier that we bought was the first ship of a class. It was a lead ship and the most optimum time to sequence carriers when you build them is between 3 and 4 years apart. I mean, the time delay between the buying of the Ford and the buying of the Bush before that was on the order of 7 years. So we probably -- if you look at the way we bought aircraft carriers since the early -- since the late '80s, the last 2 ship contract for carriers was in 1988. Since then, we've probably bought aircraft carriers as inefficiently as we possibly could. We stretched out the buying times, we then went and did a whole new design, we put a lot of new technology into the ship, and we've done that -- we've probably done that about as inefficiently as we can. What we've done is, we've taken the lessons that we've learned on that first ship, we've invested capital in our business to reduce the price of the second ship, which we have done and we've signed that contract. And we have communicated that we're taking money out of the ship. If you want to take even more money out of the ship, you've got to buy them smarter. If you want to buy them smarter, that means buy them in multi-ship procurements, 2 or 3 and narrowing the build sequence back to 3 or 4 years. If you do that, you will save money, that you can use to go buy more planes and ships somewhere else.

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

And does that resonate well if you get outside of some of the McCain or Thornberry...

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Time will tell, but certainly, any time you start talking about taking real money out of a program that you can redeploy, people want to hear what you have to say. And so I'll go back to what I said, we're at the very beginning of the '18 process. This is going to be what we talk about through the '18 process. We'll see. We'll see.

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

On the second carrier, on CVN-79, so you're on a fixed price contract on that. You've done a lot of work to take cost out. How do you see risk on that? I mean, going to the fixed price program, there are always some risks associated with that.

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Yes, I mean, you may recall that we actually delayed that contract by a couple of years going to that contract because we had such wide -- widely disparate views between the company and the Navy over how much risk there was in the program. And we needed to finish more of the 78s, so we could get through that contract. And we did that, we went through the contract. We've invested in taking significant labor hours out of the ship. We're at -- we're about 25% of the way through the ship now, and most of that's on the material side. We're just getting into the labor side of it so far. And so far, the milestones that we set for ourselves are tracking okay, but we're -- we got ways to go on the ship and we'll see how it turns out.

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

Well, going back to what you were saying about the budget. We've a long process here. The current budget, I think, is a fairly weak budget, '18 budget that has been submitted for shipbuilding. Let's say, a budget like that, that becomes the plan, if that happens, what does that mean for you with respect to the supply chain and being ready to ramp up later? Does this create a problem for you to keep suppliers on board?

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Yes, in the budget that we have now, there are 2 destroyers, there's 2 submarines, there is an aircraft carrier. And we just at the '17 budget of April, there's an LPD-29 and there's NSC-9 and long lead for NSC-10. So does that create a problem for me? No. It's just the pace of the build-up, the timing of the build-up would have to be adjusted. A lot of the discussion wants to be -- when you're in Washington, a lot of discussion wants to be binary. They present this as, you have to do this or else nothing will happen. If you don't do it this way, you'll fail. But the reality is that it's all on a spectrum. And if the '18 budget turned out the way that it did -- that it looks right, now as a hypothetical, would it create a problem in the supply chain? No. Would the supply chain be as robustly motivated as it could be? No. Does that mean we can't motivate it in the '19 budget? No. So I think that there's a spectrum here of -- I'm not altogether displeased with the '18 budget, particularly in the wake of what we got out of the '17 budget. It's not going to motivate the supply chain the way that it needs to be, but it's not going to demotivate them either.

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

Yes, it's not as though you're taking down rate volumes...

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Right, right. I mean, if you were to cut the submarine production rates from 2 per year to 1 or 0, and then say, 3 years from now we're going to be at 3, nobody would believe you. So I think it's okay. It's not great, it's not perfect, but it's not bad.

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

When we looked at the Navy budget, what it -- one thing that appeared to be going on was that there was quite a bit of money allocated toward readiness there, rather than additional shipbuilding. And -- can you talk about how Huntington Ingalls benefits from readiness spending?

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Sure. In our Services business, we have just about anywhere there's a Navy ship, we have people there. Our approach to the maintenance side of the business is mostly light on assets. We have a repair facility in San Diego at Continental Maritime, which is a pretty key part of the maintenance activity in San Diego, but we don't typically own ship repair yards around the world. We have people who are specifically qualified and trained to go and do maintenance activity and installations, alteration installations, Tiger Teams kind of stuff all over of the world in support of the Navy. And so as that ramps up, we would expect that part of our business would ramp up. That part, we separated over into the third leg of our business now in Technical Solutions. That's -- the old AMSEC business is over there now. But that's -- yes, we see opportunity for that.

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

It seems as though, given the state of the Navy right now, that could be substantial for (inaudible) reasons.

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Well, I mean, substantial compared to what it used to be for sure, substantial compared to the shipbuilding piece of the business, not really. I mean, it's going to move the business. It'll be important for us to be in it, the shipbuilding piece is still the big business.

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

On Columbia class, assuming that, that goes on plan, what does that mean for Huntington Ingalls in terms of a revenue trajectory?

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Yes. I mean, we've -- I think the piece for us is, we don't really project by any particular program where the revenues are going to go or any of that. What matters to us is that program be efficiently constructed by the supply -- by the base as they can. What we see happening is that over time, the submarine -- the nation's submarine base is going to be producing -- today, it's producing 2 submarines a year, 2 Virginia class. In the future, it's going to be producing, in addition to 2 Virginia-class, it may actually be producing another Virginia-class every year plus a Columbia-class in there every other year or something like that. And I think the question is going to be what happens to the base in those years where a Columbia-class is going to deliver? How do you manage the deliveries of the Virginia-class if that has to be delivered that same year? Because the delivery teams are pretty specialized and unique. And so we see that, in those years, we see that there could be some shifting of deliveries from our partner in

Connecticut to the guys in Newport News to try to make sure that the base does that as efficiently as possible. But that first delivery is 2026 or '27. So it's way out there. And I think in the near-term, we're just going to -- we're going to be ramping with the design in accordance with the share of the business.

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

So that's more of a -- I would presume, a cost-plus effort over the next...

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

On design? Yes, typically it's something like that, yes.

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

And what does that mean if you continue to build, let's say, Virginia-class [phase] 2 per year, continue to build at that rate, then you start to add in design work and may be some early, I don't know, production and some more work on it. What does that mean for the resources that you have at Newport News? Does that mean you're going to hire people...

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Yes, we've already started to hire people back. Because of the sequester, we actually had to let nearly 2,000 people go at Newport News, and we've begun hiring them back now to support not just Columbia, but the Virginia-class program, the Carrier program, the Kennedy ramping back up. We're going to be beginning another refueling overhaul. And before too long, we'll be starting -- we're starting into Block IV now on submarines, we're going to start talking about Block 5 on submarines. So we're at the front end of business on Newport News right now, and we had to let some people go, unfortunately, over the last couple of years because we got out of sequence. Sequester pushed us out of phase, and now it's time for us to start calling those people back. And so we're doing that.

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

And is that difficult? I mean, are those people available? Are you...

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Yes, I mean, we're generally pretty good at creating the workforce. I mean, if the people don't come back, we go and -- we're connected to the workforce development pipelines through community colleges and the other work centers in the area, and we invest heavily in our own training programs to bring people in and turn them into ship builders. And so our ability to create workforce at a rate that we need is generally pretty good. My view is that we can create a facility and the workforce in the shipyard faster than the government can appropriate the money that they want to do this ramp up. So I'm much more concerned about, are the suppliers going to make the investment they need to make to be able to keep up with our schedule. That's to me -- that's where the rub is going to be, and that's why I go back to -- you need to find ways to send signals to the supply chain that they need to invest in their physical plant, but also in their people to be able to keep up with us, because when we turn around and we need that remotely operated valve, we need to have it. That -- otherwise we become inefficient and that's not good for anybody.

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

You've often said that a good, sustainable shipbuilding business is a 9% to 10% margin type business over the long term. Certainly Newport News was in that range for quite a while, now you're in the transition from CVN-78, CVN-79, Virginia- class Block IV. The margins have come down from at Newport News. Could you talk about the factors that you see influencing those margins? And when do you see yourself getting back up to that kind of traditional level?

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Yes. I think, first of all, I think, that the blended rate applies to all of shipbuilding. So if you blend Newport News with where it's going on in Ingalls, you actually have a really healthy business. Because you've got pretty mature stuff happening at Ingalls, where they're getting really solid returns on the stuff that they're doing there. All other programs are very mature and they're in serial production, all of the places you want to be in a program. And so they're doing really well. Newport News is they're -- they just delivered the Lincoln. They just delivered -- which is in refueling, they just delivered the Washington. We're about to deliver the Ford. Newport News is transitioning from a time where they've been about 2/3 cost type. That over the next few years, it's going to be a little bit less cost type work and a little bit more fixed cost price work. But they're at, as I said, they're at the beginning of a new refueling overhaul. They're at the beginning of Block IV in submarines. They're at the beginning of the CVN-79 and they're at the beginning of the Columbia class. And the way we do business is that when you're at the beginning of that program, you try to identify all the risks that you can, and you don't take credit for it in your income statement until you retire the risk. There's not really a whole lot of a big milestones for Newport News to grab a hold of to retire that risk for a few years. So I mean, the launch of Kennedy is in 2020, I think or '21. And so the opportunity to actually take credit for the risk retirement across the broad array of programs that Newport News has, is going to be a little bit less than normal. And -- but that's just the period of -- the time period that they're in. It's not an indication they're not performing, they're actually executing really well. And I think they're positioning themselves for really solid run for a long, long period of time. They're just a little bit of a headwind right now in returns.

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

Let me -- I had an impression on Block III, Virginia-class, you were getting some very healthy margins before the Block transition. When you look at Block IV, should we expect that to go like Block III? If you go back to the beginning of Block III, I think, it was not as good. So how should we think about...

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Yes, so whenever we're at the beginning of a contract, we always kind of step back to how much risk do we think there is. The negotiation on Block IV is very different than the negotiation on Block III. The pricing on Block IV takes into account the performance on Block III. So there's a reset there from the government's expectations. And you put all of that into play and you step back and at the beginning of the program, you turn around and say "okay, here's all the risk." And it's a risk register that looks different than the risk register at the beginning of Block III. And the opportunities are different than they were at the beginning of Block III. And so now you got to start working your way through that, in the same way that you did on Block III. And we expect that to go very well, but we're not going to take credit for it until we actually accomplish it. And if you look at the submarine piece of the business 5 years ago, when the business was carrier construction, which was cost type, carrier refueling, which was cost type, and submarines, which was fixed-price incentive, well now the business mix is carriers, fixed-price incentive, carrier refueling cost type, submarines fixed price incentive, Columbia-class cost type, the percentage of the business that's going to be in the submarine place, the Virginia-class place where you have fixed-price of a mature serial production product line is actually less than it was before. So, yes, we expect great things from our Virginia -- class program, but it's just a contributor to the overall yard.

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

And I'm trying to remember the timing, when you -- when Block IV -- when you started to head the Block 5, that's about...

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Couple of years for the contract for Block 5. I mean, we just delivered Washington, which is the fourth ship of Block III. So we have 4 more ships in Block III to finish before we actually start delivering the Block IV ships. So we got a ways to go here, but we're starting to roll through them.

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

If you -- if we more over to Ingalls, that's the other side of the coin where you have very mature set of ships. And margin levels that are well above -- I remember, you and I talking here a few years ago, and we were talking about this and you were sort of trying to calm me down on margins going above 10% there. Well, you've gone way above that. Can you talk about how long a period you see where you're at these higher margins? In other words, when does the development work start to come in?

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

So I'm going to keep trying to calm you down on that. Because what happens at Ingalls when you're in a mature product line like that is that you do have a lot of opportunities to take credit for risk retirement, and those guys are doing great work. I mean, they're really retiring risk at an incredible rate. But that still risk -- every new contract has a whole new risk register. And so -- and as our practice of not taking credit for it until we see it. That's going to continue. Whenever we have something new, we're going to step back on it. They're in a place right now where they're actually delivering some things where they've really retired a lot of good risk and the retiring turns into income on our statements. So how long will that last? We take it quarter-by-quarter. And we look at the events for the quarter, we look at how that affects the risk register, and then we go forward. I think the fundamental issue at Ingalls is, can you keep attracting the business? Can this level of execution, can it continue to attract the business and capture the business that needs to be captured? We've got a competition coming up on the next multi-year for destroyers. We've got a whole question around how do you connect the LPD program to LXR? And is LXR going to be competed or not? The question of where's the next LHA after LHA-8? Where does that fit in and how is that going to fit in? The NSC program is looking like we're going to go and continue to build that line out, but I mean, if you really wanted to efficiently build the NSC program, you do a multi-year for the next 3 ships as opposed to continue to build them one at a time. And so how those things play out will have a direct bearing on how Ingall's ability to continue to execute well and retire risk. And every one of those negotiations is going to take into account. If you're the customer, you're going to step back and say, "Well, you guys are really retiring a lot of risk here" and so that's going to affect the pricing.

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

On the last destroyer competition, you won. You beat out GD, and some people worry that you might have bid that very aggressively. Your margin's certainly no indication there's problem there. So when you compare how you bid that contract to how you performed, what do you think? Have you beaten what your expectations were?

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

I think we're in line with what we expected. And I think, one of the things that we recognized after that competition was that in order for us to continue to maintain our competitive posture, we needed to reset the competitive positioning of the shipyard. And so that's what led to the whole shipyard of the future initiative at Ingalls. I mean, we could have come out of that win and said, "Hey, we won. We'll win forever" and just leave everything the way it is. But my view is that, that's a surefire recipe to fail. And so when you win like that, now is the time for us to go and try to actually be -- reset the competitive position to be even more competitive because it's important for us to win the next one. So that's what we're doing.

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

It's interesting, if I go back a few years ago when the margins at Ingalls weren't so good. One of the arguments that was often made was, "Well, you can't really compare Ingalls to Bath, because Bath builds one kind of ship effectively whereas you have a very complex mix of ships at Ingalls. It doesn't seem like that's -- it seems like you managed through that?

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Yes, I know those arguments were made, Doug, but I would say I probably wasn't the one to make too many of those arguments.

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

You were not the one that did that.

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Yes. My view is it's really hard to compare our business with anybody else. I mean nobody else is building -- Ingalls is building 4 classes of ships in 1 shipyard right now. And Newport News has got basically 4 major programs going on in its shipyard between Columbia, Virginia, refuelings and -- so it's 4 classes sitting there with Ford in Newport News. Most of the other shipbuilding businesses that are out there, at large, don't have that kind of product diversity going on at the same in the business. And so that makes for a very different comparison when you step back and start to say how do we do capital, how do we do programs, how do we do management [seat], how do we incentivize, what do we incentivize, it just becomes a very different comparison. So my view right now is I go back to the thing that I always said and I continue to say today is that a healthy shipbuilding enterprise ought to be operating in the 9% to 10% range. If you're out of the 10% range -- if you're above 10% for any length of time, it means you're probably harvesting really mature programs and you're performing very well, but your challenge is can you get enough new work. And if you're below 9%, it means you're probably starting new stuff or you're doing new work and you haven't had a chance to retire the risk. Both of those assume you're executing well. If you're not executing well, you'll be below 9%, but you'll know what you need to go fix. And our business, we've had that experience, too. So where we are today is we are executing very well across every one of our programs in both of our shipyards. The blended rate in our business today at large is between 9% and 10%. You have transparency into which part of the programs are in the front end of the cycle and which parts of the program are in the back end of the cycle.

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

And then at Ingalls, when you look at [the EGs] you're in this -- you will be heading to Flight III and you've got -- there is new technology going in there.

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Right.

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

Does that present a headwind at all in terms of margins? Or is that large of a change that we could see one?

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Well, we think -- I mean, first of all, what -- our job is to try to get as much capability into the fleet as fast as we can. And so we think Flight III is critically important to the Navy and to the sailors and to the fleet to get it out there. We see that as an engineering change to the design. We don't see that as a new design per se. It would be great if you were 100% buttoned up on the design before you ever started it. But if you do something like that, you're almost guarantee that the sailors are going to get stuff that's out of date if you do it that way. So our approach is to find a reasonable balance between maturity of design and ability to produce to get the ship to sea. You may know, we actually have a handshake on the Flight III change that goes into the destroyers. And we think that that's going to work out very well for the sailors. And we'll manage that to the best of our ability in the business.

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

On the LPDs, so getting LPD-29 was a very important thing for you. Can you talk about how you see this whole transition as you go to LPD-29, eventually onto LXR. I think there's also technology insertion there on that path.

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Yes, I mean, I think what's -- yes, it's a good question, but I think what's actually happened is that path from LPD-27 to LXR through 28 and 29 has made -- the 29 looks a lot more like LXR than you might have imagined a few years ago. I think the real question here is can you actually go right on into LXR because we need to. This idea that we're going to continue -- we've actually funded a bridge with 2 ships. The Congress has funded a bridge from the LPD program to the LXR program. While that's been really important to our business, that's not a sustainable way to run this business. I mean, we need to get into that program and get into the normal cycle of producing those ships and some...

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

So 28 and 29 were both congressional adds, right?

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Pretty much, yes. So and that's why I say the '18 budget is just the first piece of paper. We've got a long ways to go on this. But if we end up trying to fund the LXR program by adding 1 ship every year for 10 years, I don't think we can sustain that. I don't think there's an ability to sustain that legislatively. So I think we got to get -- that's why I go back to we got to get structural issues resolved so that we can do -- go do some really smart programmatic things.

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

How well defined is LXR at this point?

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

From our standpoint, we think we know what a ship looks like. We think we know what it should look like. I mean, there's a lot of probably still some discussion with the requirements guys. And in the Marines and the Navy, everybody is trying to still weigh in and say, "Here are the changes that we need to make." But fundamentally, the biggest decisions are already been made. I mean the ship is going to look like an LPD. That was a big decision that was made a few years ago to take out the cost of a new design. That's really important. I mean, for all of the other changes that happened -- anything else that happens now is pretty minor related to that decision that the Navy made. The Navy -- the CNO and the Commandant came together a few years ago and made that decision. And that's been a good path. That set the stage for the 28 and 29 bridge.

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

So that's a huge reduction both in cost and risk.

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Right. And if you can actually make the LXR look like the 29, now you got actually a learning curve that's already -- you're already in the first ship of the learning curve.

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

So do you know yet, I mean, LPD-29, do you know what that looks like? In other words, the technology insertions that aren't clear, if they'll happen there or...

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

I'd say, we -- yes, within the range of knowing what the ships look like, yes, we know what that looks like.

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

Okay. And so you can make that evolution happen and I guess, these will be repriced, right, because they're one at a time?

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Sure.

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

So yes, it's not as though you can -- you won't get all the benefit from that maturity?

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Well, I mean, if you -- let's go back to an earlier discussion about contract type. I mean, if you ended up doing LXR, you could -- if LXR looks like LPD-29, you could actually go right into a multiyear at the very beginning.

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

Okay, yes.

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

I mean, you could. We'll see if that actually happens or not. But that all speaks to how much risk there is. And if LXR-1 is actually LPD-30 or LXR-30 or something like that, and it looks like LPD-29, I'd be willing to entertain a multiyear on that.

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

So right now as you look at 28 and 29, I would assume that even though it's a mature ship, you're not going to get a lot of margin expansion from where we are today on those just because it's all...

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Yes. I mean, you renegotiated the price after 27 right so -- and then you're renegotiating the price again after 28. So I mean, there's a self-correcting factor in the contract negotiations that keep you in the 9% to 10% range at a blended rate.

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

Yes. So what about the LHAs? I mean LHA-7, LHA-8, these tend to have even more differences ship to ship. How do you manage those changes?

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Well, I mean, there were big changes where we went from LHD-8. We went from there to LHA-6 where you -- we took out the well deck. And LHA-7 doesn't have a well deck. But then LHA-8, you put the well deck back in. Those are the -- that's the big issue is, is the well deck in it or not. I think that the 6 and the 7, 6 in particular, is at sea now and everybody likes what it's doing. Not to speak for the Marines, but I would offer -- the Marines might suggestion that they wish they had their well deck back, and that's why we have it on 8. And I don't think that changes. I think 9 has a well deck, and I think that the operation of 6 and 7 will inform many other changes to 9. But I think that, compared to putting the well deck back in the ship, it will be minor, minor change.

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

LHA-9 you see as a sure thing, it's just a question of time?

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

No. I think it is a timing thing. And I think it's probably a '21 or '22 ship. And so to the extent that anything in '21 or '22 is sure, I'd say that we like to think that one is. But Doug, I take you back to a discussion that you and I have had many times. You make a list of the Navy priorities in terms of ships that they want to buy, and you make a "Here's how much money I have to go buy those ships." The money kind of always seems to run out somewhere in the amphib line. And so to the extent that the nation needs LHA-9, I absolutely believe in that commitment. I think the question is can you get all of these other things done so that the resources will be there to pay for it. I believe that they will. But that's always the fight. That's the fight around LXR, that's the fight around the LHAs. I mean it just seems like the amphibs are the scrub line, if you will, for where the money is challenged.

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

Well if we move over to the Technical Solutions segment, you've done some acquisitions, you moved the services business over there. Where do you want this to be in 5 years? What should Technical Solutions look like?

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Yes. So I think what we've done is we've tried to group together all of the parts of our business that compete the same way. And we want that business to be -- they compete the same way, it's a very -- a lot shorter-term business than the shipbuilding business. The horizon is a lot shorter, it's kind of an annual horizon sort of thing in services. Lots of competitors, lots of customers, lots of customer relations. Very entrepreneurial, very high energy kind of business. First of all, that business -- each of those businesses that are there have been successful in their own right. But they have become even more successful because they have reached back into the capabilities that are in our shipbuilding business. And so they create channels of access for customers through shipbuilding capabilities that may not have been there before. We've been, as an example, my entire career at Newport News, we've been trying to figure out how do you get involved in the DOE business because Newport News has got tremendous nuclear capability, tremendous environmental capability, really applicable to the Navy. Lots of other customers would like to have access to that, have really struggled with trying to -- how do you get over there to that space? A few years ago, we acquired Stoller, S.M. Stoller. S.M. Stoller has a presence on 25 DOE sites, and they've become broadband access to a customer that could really benefit from the capability that the shipyard has. So we married that together with the manufacturing capability that we had at Newport News Industrial. And suddenly, we have a Department of Energy commercial nuclear enterprise that's fairly substantial. And a couple of weeks ago, we were announced to be on a winning team for the Nevada test site. Now we've been on the winning team at the Savannah River test site since about 2005 or 2006 or so. We've never been able to parlay that into another win until now. And in my view, we just think that there's going to be more and more opportunity for that kind of thing as we continue to figure out how to make that work, and that aligns with our ultimate challenge of achieving the full potential of our business.

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

UniversalPegasus, how does that fit with the rest of the enterprise?

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Yes, I mean UniversalPegasus competes the same way as those other businesses. They have a whole bunch of customers. They're in the engineering services space. Our original intent there was to -- was for there to be access from the oil and gas space back in the capability of the shipyards. We're actually seeing some of that happen when the price of oil dropped and all the capital budgets dried up. Our expectation is that, that will as this stabilizes, we've now got UniversalPegasus' size right for its position in the current marketplace. As time goes on, as the capital starts to flow again there, we think that the folks who are going to be creating projects in that space, ultimately, are still going to want access back to capabilities at our shipbuilding business. And UPI is going to be pretty well positioned to do that. I mean, it's been a tough go with those guys for -- since we bought them. But I think that we're on the other side of that now. I think we've stabilized the business, we got its size right. And now we're watching a whole new set of customers that we don't have anywhere else in our business.

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

But when you look at this portfolio, do you have what you need? Are there -- are you looking for more potential acquisitions here? How do you think about it?

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

We keep our eyes open to those capabilities where we would be a better owner than whatever circumstance they find themselves in. The complementary nature of some of those things can make good sense to us. Valuations are not easy right now. But you go back to the Camber acquisition. We bought Camber, we closed on that at the end of last year. Camber was a company that we were partnered with down in -- down supporting the Navy's Sailor 2025 program. Camber had -- was supporting some Navy customers, AMSEC was supporting other Navy customers. Both of them would like to have supported each other's customers but didn't really have access. And combined, they now have a whole new set of customers that they can pursue because they have combined and they can be a much more capable opportunity -- much more capable offering to said customers there. So in that case, suddenly, we're looking at an asset where we without question can be a better owner of that business than where they were before. And that can bring its own value over time so.

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

Another small acquisition a while ago was in UUVs, unmanned underwater vehicles.

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Really small.

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

Really small, but that's an area that we've seen the Navy seems to have a lot of interest in pursuing.

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Right.

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

How do you look at that space? Is this something you see [low] opportunities?

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

I actually think, well -- I think, it's a challenging space. The physics of that space are probably as challenging as anything that we do. It's a space that we were in the sub -- we've been in the submarine business for decades, and I think from the bleachers, you would say, well, this is a natural place for you guys to be. But the submarine business is very different than the UUV business. We actually had to go and acquire the undersea group from Columbia just to understand how different it was. The fact that we have them now has created a whole lot of access to new customers. They're all Navy. So you can say it's one customer, but there are so many different customers in the Navy.

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

The Navy is big.

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

The Navy is big. And so these folks have actually introduced us to a whole new set of customers and a whole new set of opportunities. And so not a big acquisition but a really important part of our future.

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

One thing that's happened over the last couple of years is you've increased the level of CapEx you've been putting into the business, going up to -- looking at the sort of 4% to 5% of revenues level. Can you talk about how you are and intend to use that money? What are the objectives for that spend?

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Well, we took a look at the -- it's about the same time that we won the last competition on the destroyer, we started thinking about our competitive posture. And we started also factoring in where the Navy's 30-year plan was. At that point, we were already recognizing that we were -- we have the ability to execute well. And if you have the ability to execute well, and you can invest against that, you can execute even better. But you then have the opportunity to create some confidence in your customer that the plans that they have might actually come to fruition. I don't believe today that the Navy could credibly talk about a 350-ship Navy if we were not executing well on our business. I think we're too married to them and they're too married to us for, if we were not executing well, they would be spending so much time trying to figure that out that they wouldn't be able to talk about a bigger Navy. So the fact that they could talk about it says you're executing well. Now how do you invest in the business in such a way that you're going to increase the likelihood that your customers are going to be successful? When we do capital, we certainly do all of the quantitative measures that everybody does on capital with hurdle rates and everything else. But we understand this business -- having been in this business for a long time, we understand that most of the investments that we make have a whole lot longer lifetime than whatever sort of financial calculation you might do on it. I think, I told you before about a crane that we bought, used in 1910, we couldn't afford to buy it new back in 1910, but we're still using it today. So and I'm pretty sure that none of the math we did in 1910 presumed that we'll be using it today. When I went to work at Newport News, we had just opened a submarine facility designed to build Seawolf Submarines. How many of those did we build? Not any. But it became the centerpiece of the 688 program, and we won 8 of the last 10 competitions in the 688 program. It has become the centerpiece of our program on Virginia-class. 30 years later, it's the centerpiece of a 2 per year Virginia-class program and will be the centerpiece of whatever else we do, whether it's 3 per year or Columbia, wherever else it goes, and it will be for the rest of my career and probably for as far as anybody can see. And so when Tenneco did the math, they were just trying to figure out to justify that building based on half of a Seawolf program. And so the math that they did created the building, but it had nothing -- it had no relevance to what actually happened. And so when we think about capital, we do the math. We try to understand it. We try to understand what the 30-year plan is. We try to understand what our posture is, if it's a competitive posture or if it's a likelihood of improving the probability that a program will go forward. But we also try to create facilities that are going to be very long-lived multiple programs. We're going to be building stuff. And the stuff we're building today, the $1.5 billion in capital we're doing today, we're going to be building stuff in those facilities that we don't even know what that looks like right now. And so we think that that's a pretty good investment.

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

But it's an interesting decision process because on one end you have investments in a competitive programs, say on the DDGs, to help ensure that you can win in the next round. Then you have some things that are for the Navy on the specific program they're planning to ramp up that you need to prepare for. But then it's the third which is what you're talk about which in a sense is...

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Generational.

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

Yes, it's much less clear how to do a NPV calculation around that third part. But what you're saying is that, that's a necessity in this business to...

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

I think it is. I think I mean go back to the competitive position on the destroyers, you can't improve the competitive position on destroyers without improving your efficiency on all the rest of the programs in your yard. So our approach on the capital there has not been specifically tailored at the destroyer program, it's actually been, how do we improve the overall efficiency of the shipyard that's actually executing really well today. How do we do that? And we're doing that. We're automating it. We're covering it up. We're doing those kinds of things that are going to improve the efficiency of the yard. And it's going to do it for every program in the yard not just the destroyers.

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

So as you think, about cash with that backdrop of thinking about acquisitions, thinking about what level of CapEx will be, how do you think about dividends and repurchases?

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Well, our commitment on dividends is that we're going to raise the dividend at least 10% a year each year through 2020. And our commitment on free cash is that, including the dividend, we're going to return substantially all of our free cash to our shareholders. If we need to go do some acquisition, because it makes sense for us, we have the financial strength to go do that, use our balance sheet to go make that happen. So that's our commitment to you, and we're living to that.

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

Well, I guess, just to wrap up, just wondering if you could just tell, when you look forward, if you had to look at 1 or 2 opportunities, 1 or 2 challenges for you, what would they be?

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

I think, getting -- I think, it's really important that -- first of all, I believe that the Navy has got to be bigger. And I think that we have an important role in helping make that happen. And so being as efficient as we can, creating the supply chain that they need, helping navigate our way through some of the structural legislative issues, I think, our -- that's an important responsibility that we have and we take all of that pretty seriously.

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

Mike, thank you very much for joining us.

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

You bet.

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

And we'll wrap it up there.

C. Michael Petters - *Huntington Ingalls Industries, Inc. - CEO, President and Director*

Okay. Thanks, Doug. Great.
