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# EDITED TRANSCRIPT

HII - Q2 2015 Huntington Ingalls Industries Inc Earnings Call

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## CORPORATE PARTICIPANTS

**Dwayne Blake** *Huntington Ingalls Industries Inc. - VP of IR*

**Mike Petters** *Huntington Ingalls Industries Inc. - President & CEO*

**Barb Niland** *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

## CONFERENCE CALL PARTICIPANTS

**John Raviv** *Citigroup - Analyst*

**Pete Skibitski** *Drexel Hamilton - Analyst*

**Doug Harned** *Bernstein - Analyst*

**George Shapiro** *Shapiro Research - Analyst*

**Sam Pearlstein** *Wells Fargo Securities, LLC - Analyst*

**Robert Spingarn** *Credit Suisse - Analyst*

**Sam McKelvey** *Stifel Nicolaus - Analyst*

**Myles Walton** *Deutsche Bank - Analyst*

**Darryl Genovesi** *UBS Securities LLC - Analyst*

**Gavin Parsons** *Goldman Sachs - Analyst*

## PRESENTATION

### Operator

Good day, ladies and gentlemen. Welcome to the Huntington Ingalls Industries second quarter 2015 earnings conference call.

(Operator Instructions)

As a reminder, this conference may be recorded. I would now like to introduce your host for today's conference, Mr. Dwayne Blake, Vice President of Investor Relations. Sir, please begin.

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### Dwayne Blake - Huntington Ingalls Industries Inc. - VP of IR

Thanks, Mitchell. Good morning and welcome to the Huntington Ingalls Industries' second quarter 2015 earnings conference call. With us today are Mike Petters, President and Chief Executive Officer and Barb Niland, Corporate Vice President, Business Management and Chief Financial Officer.

As a reminder, statements made in today's call that are not historical fact are considered forward-looking statements and are made pursuant to the Safe Harbor provisions of federal securities law. Actual results may differ. Please refer to our SEC filings for a description of some of the factors that may cause actual results to vary materially from anticipated results. Also in their remarks today, Mike and Barb will refer to certain non-GAAP measures, including certain segment and adjusted financial measures. Reconciliations of these metrics to the comparable GAAP measures are included in the appendix of our earnings presentation that is posted on our website.

We plan to address the posted presentation slides during the call to supplement our comments. Please access our website at [www.huntingtoningalls.com](http://www.huntingtoningalls.com) and click on the Investor Relations link to view the presentation as well as our earnings release. With that, I will turn the call over to our President and CEO, Mike Petters. Mike?



**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

Thanks, Dwayne. Good morning, everyone, and thanks for joining us on today's call. This morning, we released second quarter 2015 financial results that reflected solid operational performance by Ingalls and Newport News, while UniversalPegasus continue to be affected by weakness in the oil and gas market. During the quarter, we had two events that affected our GAAP earnings. The first event was a favorable resolution of an insurance litigation matter that resulted in decreased sales and increased operating income at our Ingalls segment and an after tax increase in EPS of \$1.80. The second event was a goodwill evaluation that led to a \$59 million non-cash impairment charge in our other segment and an after tax decrease in EPS of \$0.96. All comparative data that I discuss today are adjusted for these items. For the quarter, sales of \$1.76 billion were slightly higher than last year and diluted EPS was \$2.36 for the quarter, up from \$2.04 last year. Excluding the FAS/CAS adjustment of \$0.37 per share, second quarter EPS was \$1.99, up from a \$1.75, last year. We received \$4.5 billion in new contract awards during the quarter, including the detailed design and construction contract for John F. Kennedy CVN 79, resulting in backlog of approximately \$24 billion of which \$14 billion is funded.

Since our Q1 earnings call in May, the house and senate have each past their version of the 2016 National Defense Authorization Act, and contraries are anticipated to complete negotiations on a final bill after the August recess. While progress has also been made by the house and senate on appropriations bills, final passage and enactment of these measures is contingent upon an agreement between congress and the administration regarding the balance of spending across defense and non-defense discretionary accounts. This, combined with the inability to resolve sequestration could lead to yet another continuing resolution or even worse the government shutdown would be very disruptive to our industry. We remain hopeful that these issues are resolved in a timely fashion and disruption to the industry will be minimized. At the same time, our team remains engaged with the Navy and congressional leadership on all of our programs.

Now, I will provide a few points of interest on our business segments. At Ingalls, the NSC program continues to perform extremely well as the team delivered NSC-5 James to the Coast Guard in June. In addition, the state of Mississippi executed a bill for \$20 million bond that combined with our capital investments will support a new drydock, building improvements and new covered facilities, which enable more work to be accomplished without being affected by the weather. This partnership with the state will help maintain jobs and supplier opportunities in Pascagoula and across Mississippi for years to come. At Newport News, the Virginia-Class Submarine program continued its outstanding performance of the team delivered John Warner SSN-785 to the Navy in June. Two-and-a-half months ahead of the contract schedule. On Gerald R. Ford, CVN-78 testing of the new electromagnetic launching system has gone well and the overall test program continues to support delivery in the first half of 2016. However, based on recent performance trends for this first of a class ship, we recognized an increase to the estimated cost of completion that resulted in a negative cumulative adjustment in the quarter.

Regarding UniversalPegasus weakness in the oil and gas market remains a challenge. However, initial phases of work on a few projects from UPI's key customers have recently been turned back on. In spite of these positive developments, it is still difficult to predict when the market will ultimately turnaround. As we finish the second half of 2015, our relentless focus on program execution will remain a top priority. We face many challenges, but we have a great team to work through them and keep us on track to maintain our 9-plus percent operating margin in our shipbuilding business. I am extremely proud of this team and I appreciate all the hard work and sacrifices that they make each and every day. That concludes my remarks and I will now turn the call over to Barb Niland for some remarks on the financials. Barb?

**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

Thanks Mike. Good morning, everyone. Today, I will review our second quarter consolidated and segment results as well as provide you with a few updates for the full year. Please refer to the slides posted on our website for more information. As Mike mentioned, we settled an insurance litigation matter during the quarter and received \$150 million in cash. As a result of the settlement, Ingalls' revenues declined \$13 million due to lower overhead costs and its operating income increased \$136 million. In addition, we took a \$59 million non-cash goodwill impairment charge in the other segment; where applicable all the numbers I discussed today will be adjusted for the litigation settlement and the goodwill impairment charge.

Turning to the consolidated results on Slide 4 of the presentation, total revenues of \$1.76 billion increased \$39 million or 2.3% from the same period last year, due to increased volumes at Newport News and submarines and fleet support services. Segment operating income increased \$3 million



to \$166 million, due to higher volumes at Newport News and performance improvement at Ingalls, partially offset by an operating loss at the others segment. Segment operating margin was 9.4%, which was relatively flat to the second quarter last year. Total operating income increased \$11 million to \$192 million, primarily due to higher favorable FAS/CAS adjustment year-over-year. Total operating margin was 10.9% compared to 10.5% in the same period last year. Cash from operations was \$166 million in the quarter and free cash flow was \$137 million. Capital expenditures in the quarter were \$29 million, up \$2 million from the second quarter last year. For the full year, we now expect capital expenditures as a percent of revenue to be approximately 4%. The lower than expected is all due to timing and therefore the spend will move in to 2016. You can also expect to see elevated levels of capital expenditures over the next two to three years. We will provide you with our estimates for each fiscal year during our fourth quarter call and update you as we go throughout the year.

As previously discussed, we had planned to make \$99 million discretionary contribution to our qualified pension plan this year. In the first quarter, we made a \$2 million contribution and during the second quarter, we funded the remaining \$97 million balance. Additionally, under our share repurchase program, we purchased approximately 530,000 shares at a cost of \$64 million during the quarter and we paid dividends of \$0.40 per share or \$20 million, bringing our second quarter cash balance to \$960 million. Moving onto the segment results, beginning on Slide 5 of the presentation, Ingalls' second quarter revenues of \$559 million decreased \$13 million or 2.3% from the same period last year, driven by the delivery of LHA-6 and NSC-4 and lower volumes on the LPD program. Operating margin of 11.1% in the quarter increased 78 basis points over the same period last year due to the risk retirement on DDG and NSC programs.

Turning to Slide 6, Newport News second quarter revenues of \$1.2 billion increased \$37 million or 3.3% over the same period last year, due to higher volumes on the VCS program and on aircraft carrier maintenance. This was partially offset by lower volumes on CVN-72 RCOH and the construction contract for CVN-78. Operating margin for the quarter was 9.3% or 14 basis points increase over the second quarter last year due to performance improvement and risk retirement on the VCS program; partially offset by lower performance on CVN-78 and lower volumes on their aircraft carrier RCOH programs. Moving to the other segment, revenues in the quarter were \$35 million with an operating loss of \$5 million. Project delays and work scope reductions continue to negatively impact performance.

Now, for an update on a couple of the below the line items, on July 13th, we closed an amendment to our bank credit facility and used cash on the balance sheet to replay our outstanding term loan, which was coming due at the end of March 2016. The amendment included an increase in our revolving credit facility to \$1.25 billion and \$500 million letter of credit sub-facility. Our Form 8-K disclosing the amendment was filed July 15. We now expect interest expense of approximately \$95 million for the year. Additionally, since a portion of the goodwill impairment charge is not amortized for tax purposes, we now expect an income tax rate of approximately 35% for the year.

To summarize, this was a good quarter with solid performances in our shipbuilding businesses. As I said before, this business can be operationally lumpy, but we remain confident that we will achieve the 9-plus percent segment operating margin in our shipbuilding business. That concludes my remarks for the quarter. I will turn the call back over to Dwayne for Q&A.

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**Dwayne Blake** - Huntington Ingalls Industries Inc. - VP of IR

Thanks, Barb. As a reminder to everyone on the call, please limit yourself to one initial question and one follow-up, so we can get us many people through the queue as possible. Michelle, I will turn it over to you to manage the Q&A.

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## QUESTIONS AND ANSWERS

### Operator

Thank you.

(Operator Instructions)

Joseph DeNardi with Stifel.



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**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

Good morning, Joseph.

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**Operator**

I am sorry. His line just disconnected. We are going to move onto our next questioner, which will be Jason Gursky with Citi.

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**John Raviv** - *Citigroup - Analyst*

Hi, good morning, guys. Actually Jon Raviv on for Jason.

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**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

Hi, John.

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**John Raviv** - *Citigroup - Analyst*

Hey. Just a question about just the shipbuilding margin is obviously very strong this quarter, especially in Ingalls. Could you go a little bit deeper into that 11%, what is sustainable, what is?

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**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

We delivered NSC-5, so we had risk retirement on the NSC programs. All the NSC programs are doing well, as well as we had some risk retirement on DDGs. So you heard my comment about the lumpiness in our operational performance, as timing of risk retirement. As we said before, a healthy shipbuilding business runs at about 9% margin, so that is what we expect.

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**John Raviv** - *Citigroup - Analyst*

Okay. Great. Then just as a follow-up, just thinking about your suggestion that you are confident you will achieve above 9% margin on ships. It seems like year to date you are way above that. Is this some lower expectations of those risk retirements or is there actually going to see some ramp up in some that cost-plus stuff in second half that should pressure margins?

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**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

I do not really like to say lower expectations. It's really just about timing. For example, I've talked a little bit about 78. We did not quite meet our expectations there of retiring the risk we wanted to, so it is really just timing of when those risk retirements occur. I go back to my, a healthy shipbuilding businesses in a 9%-plus range of margin.

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**John Raviv** - *Citigroup - Analyst*

Thanks. I will jump back in the queue.



**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

Okay. Thank you.

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**Operator**

Pete Skibitski with Drexel Hamilton.

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**Pete Skibitski** - *Drexel Hamilton - Analyst*

A little bit of a forward-looking question on the Newport News layoffs. Should we read that as an indicator? Directionally next year, should we think of Newport News being down?

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**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

We have talked before about the Newport News piece of the business being a little bit out of balance with three aircraft carrier deliveries over the next year-and-a-half or so. The signing of the 78 contract is helpful, but it doesn't solve the problem for us. What happens on the other side of that is, we start to ramp back up again. But we are going to have to go through a little bit of a reset of the business over the next year-and-a-half to two years.

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**Pete Skibitski** - *Drexel Hamilton - Analyst*

Okay. On the other side, could you connect that at all to Ingalls? Is there possibility for Ingalls to offset at all?

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**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

The Ingalls business is a little bit more, from a business development standpoint, is a little bit more dynamic than the Newport News piece. There is certainly a lot in front of Ingalls that I would say is in the go-get category, LPD-28, for instance, successfully resolving the competition around TAO and LHA. What happens to LXR? You know quite frankly, what sits over top of all of this is how is how is ORP going to get paid for? If ORP is going to be paid for outside of the shipbuilding budget, then a lot of things in the industrial base work out really well. If it gets taken out of [high], then there is going to be a tremendous negative impact to the industrial base for, especially for non-nuclear ships. That to us is the big issue, is getting ORP funding sorted out.

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**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

Pete, I will follow-up with, we said we will have flat revenues, and you are spot on with three carrier deliveries over the next 18 months or so. You will see some pressure on volume at Newport News. But at Ingalls we have, I think, it is 11 ships in construction right now, and they are going on full cylinders over the next few years. What Mike was talking about is outside of that window, so there could be some movement between the balance there, but we expect to be in a flat range.

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**Pete Skibitski** - *Drexel Hamilton - Analyst*

Thanks, guys.

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**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

Thank you.

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**Operator**

Doug Harned with Bernstein.

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**Doug Harned** - *Bernstein - Analyst*

Yes. Good morning.

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**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

Good morning.

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**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

Good morning.

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**Doug Harned** - *Bernstein - Analyst*

I would like to continue on Newport News, because when you look at this transition, which is leading to workforce reduction, is this something that is how you would view it as a normal transition as you deliver the Ford next year, ramp up on the CVN-79? Is this a normal transition or does this tie into some of the funding issues that we have seen over the past few years in terms of the timing of availability of funds?

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**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

I think it is probably a mix of both, Doug. There is always a reset of the business when you have a delivery, especially the magnitude of the delivery of the Ford, but it certainly has not helped us that the sequestration debate has delayed the refueling by a period of time. The George Washington is supposed to come in, but it is coming in later than we had originally planned, so and that is driven by funding.

The discussion about -- what? About two years ago, there was big discussion about whether it would even be refueled or not. All these funding issues and the political discussion around that has contributed to the imbalance. It is not the sole cause, but it certainly has contributed to that imbalance of deliveries happening without follow-on work being there.

We went through a long period here of negotiation on the CVN-79. That was particularly challenging for everyone, because we were all trying to figure out how do you move to a price-type contract when you are not all the way through the first ship, and how do you manage the risk and how do you budget for the risk and how do you contract for the risk? The solution to that was to delay the contract to -- we are very happy to have it here this year, but by delaying that contract, that contributes to some of what is going on here.

In a normal case, you would like to actually be able to have folks come off of a program and roll right back into the follow-on program and not miss a beat. Some of these, there is a few various factors there that have contributed to this little bit of imbalance and we have to reset the business looking forward, so that we can minimize the impact of that.

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**Doug Harned** - *Bernstein - Analyst*

Then related to this would be the role that you ultimately have on Ohio-class replacement. Right now, I know you are doing some work. Could you talk about what you are doing today and what you are looking for to clarify the role that you will likely have going forward on that program?

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**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

Well, I think, all I want to say about this is that, how we how we participate in the submarine construction for the country is all under discussion at this point, because the submarine industrial base that produces the Virginia-class will still be now called on to produce the Ohio replacement program.

When you take a ship that is the size of Ohio and you put it into that base, it is going to have an impact on various parts of the base. So the discussions that we are having between us and our partner and our customer are all about how do we do all of the submarine work as efficiently as possible. Without trying to handicap or predict how all that is going to turn out, I would just say, we expect to be fully engaged in the production of submarines for this nation for the foreseeable future.

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**Doug Harned** - *Bernstein - Analyst*

Is it fair to say that what you are looking at, it is a really a corrective discussion on the future roles on Ohio-class replacement on Virginia-class, that this is all being done as one large entity in a sense?

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**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

Yes. I think philosophically that is what we are trying to do. The realities of appropriations in the far drive you into stovepipe sometimes. But even when you are in the stovepipe of a particular program, you can still stick your head up and look around and see what is happening across all the programs of similar types. So, yes, that is what we are doing.

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**Doug Harned** - *Bernstein - Analyst*

Okay. Thank you.

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**Operator**

George Shapiro with Shapiro Research.

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**George Shapiro** - *Shapiro Research - Analyst*

Yes. Good morning. Barb, the cash flow looked somewhat weak to me, even if I adjust for like the \$97 million of pension you had. And receivables were up not a lot, but up another \$25 million despite delivering the NSC-5. So where does that receivables go for the year and maybe you could talk a little bit about how -- obviously, you have a strong cash flow usually in the second half, particularly last quarter. Maybe talk a little bit about where that goes?

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**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

Yes. Well, I think we are right at schedule. We did not have -- timing of our receivables this quarter was not as good as -- certainly not as good as December. Really, it is just timing. I talk about that all the time. I do not really expect to see much of a difference. We'll still pick up a little cash as we continue the rest of the year, so I do not see anything out of the norm.



**George Shapiro** - *Shapiro Research - Analyst*

Okay. One you, Mike, if we look at the impairment charges other now, so you have written off of almost half of the price you paid for this business about a year ago. My question is, if oil prices stay about where they are now, it seems to be the prevailing view. What can we look forward to in that business? Do we lose \$5 million a quarter going on, or if you can give us some color on that?

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**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

I certainly have proven my inability to forecast this market, so I am probably going to defer whatever happens to the price in the future. What we set out to do when this market was disrupted was to make sure that we preserve the key capabilities that our customers needed while they sorted through the impact to their capital spending plans for the stuff that we do.

I actually think we made some progress over the last quarter from where we were first quarter and coming through this. What we are watching now, as Barb indicated in her notes, is that our customers are coming through their thinking on what current market conditions mean to their capital expenditure plans.

We are right on the front end of that. We have maintained key capabilities so that we can support that. Our customers are aware of that. They know that we are leaning into this to help them get their way through that.

We are going to see how this plays out. I think that we made great progress, but we have not solved the whole problem yet. That's, -- I think where we are now is probably lines up with how this might go for the rest of the year, but it depends on how the capital projects come forward that we are anticipating.

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**George Shapiro** - *Shapiro Research - Analyst*

Okay. Thanks.

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**Operator**

Sam Pearlstein with Wells Fargo.

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**Sam Pearlstein** - *Wells Fargo Securities, LLC - Analyst*

Good morning.

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**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

Good morning, Sam.

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**Sam Pearlstein** - *Wells Fargo Securities, LLC - Analyst*

Can I just follow up on the UPI stuff? Was any of the write-down, does that affect any of the ongoing cost on the intangible amortization, or is this purely goodwill and there is no benefit to future reported results?

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**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

Yes. I wish there was. It is all goodwill unfortunately, so no impact on the purchase intangible, so that will continue to be a drag.

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**Sam Pearlstein** - *Wells Fargo Securities, LLC - Analyst*

Okay. Then just follow -- on the capital spending plan. I know you are waiting -- some of it was for the Kennedy contract, but others -- it did not step up that much from Q1 to Q2. How quickly can you actually ramp up that spending? I know you said 4% of sales for the year, but just in terms of thinking about even next quarter. How much of a step up we start to see?

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**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

Sometimes they can surprise me at how quick they can spend things. It really depends on what the project is. If it is, we have to construct it or is it we are just buying something, so I think it just depends. I would expect us to ramp up over this quarter in the third quarter. Then we always have higher spend in the fourth quarter of capital.

The thing to remember, though, if do not spend it all this year -- I did not release the capital on 79 until we got the contract, so that got delayed. As Ingalls -- I have not released all the capital because they are still doing the proof-of-concept and the engineering studies. As soon as they come through with that, we will release the capital.

But what will happen is, it is all going to slip. Whatever I do not spend this year will slip into 2016, so we could have some higher capital in 2016, just because we are moving stuff from 2015 to 2016.

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**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

To put some context on it, this is not just capital, where we are buying new stuff to put in the shipyard. We are modifying process and facilities that are existing today that are building the 10 or 11 ships that we have under construction. So we have got we got to actually do this investment in a way that does not disrupt the work that we are doing already. There is a pretty synchronized plan for investment here that we are always modulating as we go forward, which throttles the spending a little bit.

The main thing we want to say is that we are committed to making this investment. It is a top priority for us to invest in our core business, and we are going to do that as prudently as we possibly can. It may be a bit lumpy in the way that comes out.

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**Sam Pearlstein** - *Wells Fargo Securities, LLC - Analyst*

Okay. That is great. Then is there any update on, in terms of the plans on Avondale? I know that you had pushed off the JV discussion. Is there anything new happening there?

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**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

Nothing new, what we have done is, we continue to look at all alternatives, including sale. It's a -- we look at it daily. Let us just put it that way. But there is nothing new to report.

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**Sam Pearlstein** - *Wells Fargo Securities, LLC - Analyst*

Thank you.



**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

You are welcome. Thanks for joining us.

**Operator**

Robert Spingarn with Credit Suisse.

**Robert Spingarn** - *Credit Suisse - Analyst*

Good morning. A couple of questions, first, Barb, are you able to quantify any of the positive and negative EACs?

**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

Well, yes. The favorable adjustments for -- I think I talked a little bit about this earlier, was risk retirement of VCS and the NSC programs as well as DDG. Then an unfavorable I talked about was, CVN 78 and then some little knits and knats.

**Robert Spingarn** - *Credit Suisse - Analyst*

Any dollar amounts?

**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

Have not given any dollar amounts. I could tell what we release in the Q. We had \$92 million of favorable adjustments and \$21 million of unfavorable adjustments, so a net \$71 million.

**Robert Spingarn** - *Credit Suisse - Analyst*

Okay. Well, thanks for that. Mike, for you, got the 79 contract. We've talked about in the past that it is a different contract structure, and it does have a significantly lower ceiling. How do we think about margin mix at Newport News as we go forward here, as you transition from 78 with the cost plus structure, now 79 fixed-price steep share line et cetera? How do we think about that?

**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

Well, I think it is fairly straightforward. It is a brand new contract. We are on the front end of it. We will not take credit for retiring the risk of the program until we have retired it. Working the risk register on that contract was what that negotiation was all about and why it took so long. We will probably, as we do in all of our programs like this, we will start with a fairly modest booking rate until we retire risks associated with it and we step up into it.

The mix at Newport News, though -- so I say directly, Rob, over the over the first couple of years of the program it is going to be pretty modest on 79. The mix at Newport News will still be driven by the submarine program, the refueling overhaul program and the carrier construction. The carrier construction is the one that over the next 5 to 10 years is going to change from being cost-type that it has been, for the last that five or eight years or so, to this price environment.



On the on the back end of that, you would see more opportunity. But at the front end, it is going to be pretty modest. So the submarine is a fixed price environment, fixed-price incentive environment and the refuelings are in a cost-type environment as well. The mix is not going to change a whole lot on the front end, I would say.

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**Robert Spingarn** - *Credit Suisse - Analyst*

Right, so that 79 would be, I do not know, what? 20% of Newport News or some number like that 20%, 30%?

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**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

Yes. You take a really dull knife and you would say one-third, one-third, one-third, but that's actually not too far off over time. On the front end of the program, you are buying material. We have been buying material. We have been doing some advanced construction, if you will. It will move ahead into labor in the middle and the back end of the program.

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**Robert Spingarn** - *Credit Suisse - Analyst*

Right. Then just the last question somewhat related, but as the Ohio-class replacement comes in, how do you think about, given the funding considerations you already addressed, is there a risk here that other things might get crowded out? We know the priority on [SSB&X] is very high. Are certain types of programs at greater risk of competing for money here, submarine versus carriers versus resurface ships?

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**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

I am not exactly sure how to handicap who. But I can tell you for certain that, if you can't find a separate way to pay for the Ohio replacement program, other Navy ships will not be built, and that is a big problem. I think the Congressional Research Service, a few years ago, put a report out that had an estimate of maybe something like 50 ships would be changed. Their schedules would be change or not built at all.

So as you try to handicap the success of any particular program in the next 5 to 10 years, it does not matter what the program is, you start with the question of how is Ohio-class is being paid for? It is that important to this industry to get that sorted out.

Now, my own view is -- and we have talked about this for a long time, my own view is that the Navy has a priority list of carriers and submarines, destroyers and amphibis, and kind of in that order. You know, we been working really hard on the ambhib piece, because we have felt that that is where the pressure for funding is going into -- the resources run into where the demand line is.

Some of what the Navy has said about how they might pay for things in a sequestered environment, they have actually started to talk about change in destroyer profiles. You can see that, if it gets funded out of the normal shipbuilding account, it will absolutely have a negative impact on our industry.

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**Robert Spingarn** - *Credit Suisse - Analyst*

Given that carriers are as important as they are, in order to keep quantities, do you think maybe they just adjust center lines?

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**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

Probably. The law of the land is that we have 11 aircraft carriers. That law has been reaffirmed by the Congress the last couple years. So in order to keep it at 11 from a Navy-plan perspective, you've got to keep the path going. If the Navy's plan right now is that CVN-80 is an FY18 ship. That sits right in the middle of this whole debate.



**Robert Spingarn** - *Credit Suisse - Analyst*

Right. Well, thank you very much for your color.

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**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

You bet.

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**Operator**

Joseph DeNardi with Stifel.

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**Sam McKelvey** - *Stifel Nicolaus - Analyst*

Hi. This is Sam McKelvey on for Joe DeNardi.

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**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

Good morning.

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**Sam McKelvey** - *Stifel Nicolaus - Analyst*

Good morning. Given what the stock did after the first quarter, I thought you would have been more aggressive with share repo in the second quarter. Is the plan not to be more opportunistic during periods of underperformance? Should we expect a more steady buyback?

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**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

I think what you are seeing, if you are really just looking at the share count, you are seeing the averaging effect. I think wait till next quarter, you will see a little different labor in the share count there. It is just timing.

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**Sam McKelvey** - *Stifel Nicolaus - Analyst*

Okay. Thank you.

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**Operator**

Myles Walton with Deutsche Bank.

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**Myles Walton** - *Deutsche Bank - Analyst*

Thanks. Good morning.

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**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

Good morning.

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**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

Good morning.

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**Myles Walton** - *Deutsche Bank - Analyst*

The question I wanted to go to was the margins at Ingalls. And, Barb and Mike, I know you have both talked about a healthy shipbuilding business at 9% plus margins. But it does not seem like you are entering the promised land at Ingalls with 11 ships in production, hitting serial production stride. I think this is the largest positive [keem] adjustment quarter that you guys have put up. I am just curious in the near term, the next 18 months, 24 months, is this a sweet spot for Ingalls' margins?

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**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

Okay. I am going to take this one. I talked about the lumpiness. I always talk about the lumpiness of cash. There is a lumpiness on the risk retirement. We had a great quarter at Ingalls with several events. I will repeat my expectations at the end of the year are Ingalls margins will be in the 9%-plus range.

Please don't expect us to end the year at total margins of 11.5%. It's just all related to timing of events that occurred.

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**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

Myles, actually, we have that ability. There are some quarters, where we do not the risk retirement that we are looking for or the schedule moves or something like that, and it -- surprise is not right word, but it puts pressure the other way. That is why we try to talk about this as in not just one quarter, but talk about it over a about a period of time the businesses are going to operate in the 9% to 10% range.

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**Myles Walton** - *Deutsche Bank - Analyst*

I am definitely not trying to suggest that you are going to do 11% this year. I am just looking at that the risk in that business. It does look like you are in, more or less, your heart of serial production where you wanted to be a few years ago. If the 9% to 10% is a healthy range, then you are in the healthy part of where you wanted to be. Is it disconnected to think you would be in the upper end of that healthy range of operating margins?

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**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

Well, I think we have made great progress, as you point out. We have made great progress in moving forward and getting these programs into serial production. Some of the serial production is the work that you are doing, but some of it is the working that you are bringing in.

Bringing the LXR program forward is a very important piece for Ingalls. Now I am going all the way back to my Ohio replacement discussion. Getting that program brought forward and bridging from the LPD serial production line that we have established through LPD-28 to LXR, that is certainly the most efficient way to drive that program. That becomes really important to where Ingalls goes over the next five years or so. We are doing really well at Ingalls right now, after years of hard work to get to this point, but now it is a matter of making sure that we sustain it.

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**Myles Walton** - *Deutsche Bank - Analyst*

Just a clarification, Barb, I think you said the CapEx that you were planning for this year slid into next year. Just from a calibration perspective, will next year's CapEx be \$50 million higher than this year because of that?

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**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

It could be, yes.

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**Myles Walton** - *Deutsche Bank - Analyst*

Okay. All right. Thanks.

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**Operator**

Thank you.

(Operator Instructions)

Darryl Genovesi with UBS.

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**Darryl Genovesi** - *UBS Securities LLC - Analyst*

Hi. Good morning, everybody.

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**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

Good morning.

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**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

Good morning.

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**Darryl Genovesi** - *UBS Securities LLC - Analyst*

Mike, just to follow-up on comment you just made a second ago regarding the transition from LPD-28 to LXR. Can you give us a little more on what that transition might look like? For instance, do you need another ship to get you there? If so, do you think there is appetite, either at the Navy or I guess more specifically on the Hill, to make that happen? Then along the same lines, when is the LXR class planning work scheduled to start?

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**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

Yes. There is a lot in that. I think the first thing that I would say is that because we were able to reset the LPD program and create the production line and have the success that we have had in that program, we were happy that the Navy and the Congress recognized that, let's take advantage of that. Let's make the LXR look more like an LPD than something else, and let's bridge from the hot production line to that new class of ships and created the LPD-28.



The LPD-28 really is the 12 LPD, which was what the original requirement for that program was in any event. So a lot of support for that from an operational standpoint and from an industrial base standpoint to drive through the success of the LPD program into the LXR program.

Now how that plays out relative to the timing and the design pieces, the more we make it look like an LPD, the less you have to put into the design in terms of getting ready to start. The closer you can get it to the production line of the LPD-28, the less need you would have for another opportunity to bridge. All of that is sort of in play at this point.

Clearly moving the program forward is a big step. But I have to say, that it is right in that sweet spot of how do you pay for ORP while you are doing this? The Navy has, I think, done a really good thing here to try to button this thing up ahead of that program.

We stay engaged with that process to make sure that they understand what it will take to be successful.

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**Darryl Genovesi** - UBS Securities LLC - Analyst

Great. Thanks for that. Then, Barb just on pension. I think last year you had commented that, I think 25% of the CAS harmonization benefit had come through to you in 2014. Assuming your CAS reimbursement this year is in line with your guidance, is there a similar number for this year in terms of how much of that CAS harmonization impact will have come through by the end of this year and how much remains?

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**Barb Niland** - Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO

Let's see, from a cash perspective, are you looking for the CAS recovery in excess of the cash contribution?

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**Darryl Genovesi** - UBS Securities LLC - Analyst

I was just looking for the absolute CAS reimbursement, but however you've got it is fine.

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**Barb Niland** - Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO

Okay. The CAS recovery in excess of the cash contribution, we expect it to be around \$140 million for the year.

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**Darryl Genovesi** - UBS Securities LLC - Analyst

Right. I guess, what I was getting at is, last year you had commented that 25% of the CAS harmonization benefit had come through, right?

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**Barb Niland** - Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO

And that last year was like \$68 million.

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**Darryl Genovesi** - UBS Securities LLC - Analyst

Okay. I guess, what I am asking is, if you have essentially realized all of the benefit from that as you plan to at this point, or if there is a further step-up to come in 2016?



**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

It will still -- because harmonization won't be complete yet, so we will still have a little bit of a benefit.

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**Darryl Genovesi** - *UBS Securities LLC - Analyst*

Okay, but you do not have the analogous 25% number versus --?

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**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

Since it goes in ratable, so it is 25% and 50%, 75% and 100%.

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**Darryl Genovesi** - *UBS Securities LLC - Analyst*

So this is 50?

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**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

Right.

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**Darryl Genovesi** - *UBS Securities LLC - Analyst*

So it will be over four years?

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**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

Right.

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**Darryl Genovesi** - *UBS Securities LLC - Analyst*

Okay. Great. Then, I guess just with the move up in interest rates that we have seen year to date, does that impact your view on how much to over fund the plan here over the next couple of years? Or are you thinking about it independently about it?

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**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

Well, actually, I think I included that in the thought process, and when you think of the improvement in the discount rates, it has not solved all the problems. I think we had a 24 basis point improvements since December year end, so certainly it give us a change in our pension liabilities, significant change. I think it is like \$220 million.

But when I look at my asset returns through the end of June, I am looking at about a 50-basis point asset -- a 0.5% return. If you recall my assumption in all my analysis is a long-term rate of return of 7.5%.

Now, last time I looked, about two weeks ago, we were like at 2.1%, so the volatility of that -- so I have to look at everything. I have to look at, certainly, increasing in the discount rate solves a lot of problems, but the flipside of that is my asset returns have been a little weaker than they were the past couple of years.



**Darryl Genovesi** - *UBS Securities LLC - Analyst*

Great. Thanks very much.

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**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

You bet.

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**Operator**

Noah Poponak with Goldman Sachs.

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**Gavin Parsons** - *Goldman Sachs - Analyst*

This is Gavin Parsons on for Noah. Good morning, everyone.

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**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

Good morning, Gavin.

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**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

Good morning.

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**Gavin Parsons** - *Goldman Sachs - Analyst*

Taking longer-term view, you talk a little bit about two to three years as being the timeframe where Department of Energy opportunities really start to materialize. You sized a pretty large market there. I was hoping you could talk a little bit about how you are planning for that currently, how you think about your current scale and capabilities relative to that \$60 billion you have talked about?

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**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

First, that \$60 billion is over the next 10 years, not over the next two or three. The first of those opportunities come up in the next two or three, so what we have been working on is establishing the relationships with the other folks in the industry to determine how best to prosecute those opportunities as they come forward.

We have had -- our acquisition of Stoller and the creation of SN3 has put us in a really good place to be a good partner or maybe even more as we go forward into that business. At this point, it is we are right on the very front into that.

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**Gavin Parsons** - *Goldman Sachs - Analyst*

Okay. Great. On unmanned, the Navy actually ordered a decently sized contract last month. I was just wondering if you are still thinking about it as more of an experimental market or if you are seeing more support in funding? And how you think about the market size over the next decade or so?



**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

I am sorry on which market?

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**Gavin Parsons** - *Goldman Sachs - Analyst*

Unmanned submersibles.

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**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

Unmanned, I am sorry. I think -- and I admit my Safe Harbor provision here being a former submarine guy, I think the undersea domain is a space where there is going to be lots of opportunity. The question is, is there going to be a lot funding there.

I do think that there will probably be opportunity to translate some of what is happening on the commercial side of industry undersea to what the requirements might be for the Navy and for the Pentagon.

Our acquisition from the Columbia Group earlier this year puts us in a little bit different place than we have been before to marry up our submarine experience here in Newport News with some of the rest of that market space. We have done some things there, but we now have entree and presence that we have not had before, so we are excited about that market. We want to make sure that we go where our partner and where our customer wants to go there and make sure that we support them in the best way possible.

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**Gavin Parsons** - *Goldman Sachs - Analyst*

Great. Thank you.

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**Operator**

Jason Gursky with Citi.

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**Unidentified Participant** - *Analyst*

Hi, guys. It is actually Jason with [Diamond Hill]. Hey, Barb, just a quick question for you on cash flows and CapEx. Can you provide, here in the near term for 2015, just the varied moving pieces that could push cash flows either higher or lower? Just as you view the back half of the year, the things that have maybe got some variability to them?

Then on CapEx, as we move out into 2016, you talked a bit about some things slipping from this year going into the next. As you are assessing what happens going forward, what are the major topics that you are trying to get your head around with regard to CapEx? Is it things that are within your control? Are you waiting on others to make some decisions? Just help us better understand the topics that you are grappling with there as you're trying to figure out what CapEx levels are going to look like going forward? Thanks.

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**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

I will take the CapEx one first. As I said, we are actually investing pretty heavily in a shipyard that is operating at a pretty good pace right now. So, we're going to go in and modify the process flow where the facilities of the tooling in a particular facility, we have to do that in a way that does not disrupt the current practice or the current flow that we need to have through that facility. We actually are managing this from, what is the program plan for how we implement this?

As the ships are moving through the manufacturing phases and we want to go and put in some new facility or some new equipment and maybe some automation, we have to decide when is the best time to cut that into the facility. That's a pretty -- we have a lot of flexibility there, but it is dynamic. But we have to be very coordinated and synchronized as we go and do that, which whether we are talking about the something as binary as the launching dock or something more like modifications to our whole fabrication facility, all those parts are moving, so that is how it becomes pretty lumpy.

It is hard to handicap how that is going to play out over the next month by month or quarter by quarter. Our message is that we are committed to making the investment and it is not a question of if, it is more of the question of when.

I guess the other question was about cash, and I will let Barb take that.

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**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

Yes, I think that I have talked about earlier that CapEx as a percent of revenue would be in the 4% range. The rest of it will slide to 2016. Earlier, I think it might be Pete or someone asked me, about \$50 million sliding into 2016. That is about right. It depends on whether we spend the rest of it this year or not. We have planned projects. It is just the timing of releasing those projects.

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**Unidentified Participant** - *Analyst*

Okay. Other areas of cash flow, my question was a bit more geared toward other moving pieces as you look out into the end of the second half of the year that could move cash either higher or lower just worry points, I suppose?

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**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

Move cash higher or lower? Really it's timing of receipts, receivables, what happens at the end of the year, it will be timing of CapEx and whether we can spend it. Somebody asked me if we could spend it. Sometimes they surprise me at how fast they can spend it.

Like I said we have projects in place, so it is not a free checkbook for them. I think we have finished all our pension contributions, or our discretionary for our qualified plans pension contribution. So I think I have covered all that the big cash puts and takes.

Just remember that litigation settlement that we had, the \$150 million, I have to give some of that back to the government and pay cash taxes on that, so do not count that as \$150 million. I think I hit the big things that affect cash there for you.

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**Unidentified Participant** - *Analyst*

Okay. That is perfect. It's exactly what I was looking for. I appreciate it.

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**Barb Niland** - *Huntington Ingalls Industries Inc. - Corporate VP, Business Management & CFO*

Okay. Thank you.

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**Operator**

Pete Skibitski with Drexel Hamilton.

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**Pete Skibitski** - *Drexel Hamilton - Analyst*

Yes, a couple of follow-ups, so let me start with cash deployment. Hey, guys, you've got the insurance recovery. It looks like if we look out, the balance sheet is really in good health and the free cash, I would think you have got pretty good visibility, but a pretty good converter. It seems like you can probably ramp up the share repurchases, maybe at least like \$200 million a year or so, particularly where the stock is trading. I just want to get your updated thoughts post the M&A phase you have been through here? Do you shift on the capital deployment front? Just your thought that would be great. Thanks.

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**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

Well, our thinking on this, in some ways, is maturing. We have come through a phase the last -- since 2011, where we have been focusing on operational efficiency, and we have been looking for opportunities to create new value. We are in a place now -- we have been talking about balanced cash deployment schedule.

How we think about it today is that our first priority -- we still want to be fairly balanced. Our first priority is to invest in our core business, so we have gone forward and we have made sure that it is clear, the things we are investing in and that you see, we have had a lot of discussions this morning about capital.

We will continue to look for ways to create new value in the business. We have had some success there and we have had some learning there as well. As we go forward, we factor that into the way that we think about those opportunities.

We have been bringing the shareholders along, and there is probably opportunity to do even more of that going forward. I do not want on front of my Board or anything else, but I think we want to continue with a balanced plan, prioritize towards investing in our core business with a thought towards how we create new value and a commitment to bringing our shareholders along.

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**Pete Skibitski** - *Drexel Hamilton - Analyst*

Very helpful, Mike, thank you. Just last follow-up for you, could you talk about this idea -- I think NAVC is considering of having commercial companies maybe do nearly the full deactivation of the enterprise. I know that is been talked about. I just wonder, how far along that is at this point? And could it be an opportunity for you guys?

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**Mike Petters** - *Huntington Ingalls Industries Inc. - President & CEO*

Well, we are doing the inactivation of the ship, right now, in the shipyard. And the question that you are asking is, so what happens after we finish? I think that discussion is ongoing with our customer. What is the right thing to do and how is the best and most efficient way to get this done?

If there is an opportunity for us to participate in that, we will pay close attention to it. We certainly bring some skills to this today that we did not necessarily bring to it, maybe five years ago, with the creation of SN3 and the environmental work that Stoller does and those kinds of things. We do bring some capability there that we did not have before. There is some -- there are other players in the industry that are willing to participate in this as well.

There is a lot more to come on this, I think, but at this point, we are all trying to talk about how is the most efficient way to get this done.

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**Pete Skibitski** - *Drexel Hamilton - Analyst*

Great. Thank you.

**Operator**

Thank you. This now does end our Q&A session. I would like to turn the conference back over to Mike Petters for any closing remarks.

**Mike Petters - Huntington Ingalls Industries Inc. - President & CEO**

I thank everybody for their participation today and for your interest in our Company. I do want to let you know that we have come through. We started in 2011 and said where we are going to be at by the end of 2015. As we come up to the end of 2015, we do recognize that we need to tell you where we are going from here.

To that end, we are planning for an investors' conference to be held in New York on November 10. We will have a reception on the night before that, and we will have a chance for you to come and see and talk with our leadership team about all the different parts of our business. We would like for you to, if you do not mind, consider this a save-the-date announcement, if you will. November 10, we would be happy to see you in New York.

Thanks for your interest in our Company, and we look forward to seeing you soon.

**Operator**

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program, and you may all disconnect. Everyone, have a great day.

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