L3 Technologies (LLL)

Updated January 17th, 2019 by Prakash Kolli

Key Metrics

Current Price:	$184	**5 Year CAGR Estimate:**	5.3%	**Volatility Percentile:**	25.8%
Fair Value Price:	$159	**5 Year Growth Estimate:**	8.0%	**Momentum Percentile:**	40.3%
% Fair Value:	116%	**5 Year Valuation Multiple Estimate:**	-4.4%	**Growth Percentile:**	73.1%
Dividend Yield:	1.7%	**5 Year Price Target**	$216	**Valuation Percentile:**	23.1%
Dividend Risk Score:	B	**Retirement Suitability Score:**	C	**Total Return Percentile:**	25.2%

Overview & Current Events

L3 Technologies (LLL) is a leading provider of defense communication and electronics systems that was formed in 1997. Today the company has a market capitalization of $14.4B and annual revenue of $10B making it one of the ten largest defense contractors. The company generates approximately 69% of its sales from the U.S. Department of Defense, prime contractors, and other government agencies. The remainder of sales is to foreign governments (17%) and commercial customers (14%).

L3 Technologies reported a solid Q3 2018 on October 15, 2018. Net sales increased to $2.5 billion, a 10% YoY increase while diluted EPS were $2.54, a 42% YoY increase that was strongly affected by a reduction of the company's effective income tax rate from 24% to 8%. But profitability also improved as operating margin increased 70 bps to 10.8%. The company guided for higher EPS for 2018 indicating that revenue increases and tax benefits are benefiting the bottom line. Notably on October 14, 2018 the company announced a $15B merger with Harris Corporation to create L3 Harris Technologies in an all-stock transaction. Shareholders of L3 will receive 1.30 shares of Harris for each of their own shares outstanding. The merger is expected to close in mid-2019 pending regulatory approvals creating the sixth largest defense contractor with combined revenue of $16B, a market capitalization of over $30B, and FCF of over $1.5B. The combined entity will have an even stronger presence in defense communication and electronics systems allowing L3 Harris to more effectively compete for defense prime contracts.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	$6.98	$7.39	$8.25	$9.03	$8.12	$8.54	$7.56	$3.44	$8.21	$9.46	***$9.82***	***$14.43***
DPS	$1.20	$1.40	$1.60	$1.80	$2.00	$2.20	$2.40	$2.60	$2.80	$3.00	***$3.20***	***$4.20***
Shares	122.4	117.4	115.1	105.6	97.6	91.1	87.8	81.9	78.8	79.6	***77.2***	***66.3***

In the past 10-years L3 has had volatile EPS that were partially due to spin off and sale of discontinued operation including the spin-off of Engility in 2012 and sale of the National Security Solutions in 2016. However, L3 has grown EPS since 2015 and should see an increase this year of 3% to 4.5%. The bottom line is being driven by organic growth, tax cut benefits, improving profitability, and share buybacks. In particular, ISR Systems increased revenue by 14% while Electronics Systems increased revenue by 19%. Operating margin improvements at ISR Systems of 340 bps have driven profitability but this was partially offset by margin declines in Communication & Networked Systems of -140 bps and Electronic Systems of -30 bps. Notably, L3 has historically conducted large share buybacks and share count is down 35% since 2008 driving EPS improvements. But share buybacks have recently slowed indicating that revenue growth due to increasing DoD funding and tax cut benefits are primary EPS growth drivers. We forecast 8% annual EPS growth for the next five years without incorporating future merger related revenue or cost synergies.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	13.8	10.1	9.7	8.2	8.8	10.4	15.4	34.6	16.8	18.4	***18.8***	***15.0***
Avg. Yld.	1.2%	1.9%	2.0%	2.4%	2.8%	2.5%	2.1%	2.2%	2.0%	1.7%	***1.7%***	***1.7%***

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L3's current PE ratio of 18.4 (using expected 2018 EPS) is greater than its 10-year average of 14.7 and 10-year median of 12.1 suggesting that the stock is overvalued on this metric. We believe that the PE ratio will decrease to 15.0 over the next 5-years, a value slightly greater than its long-term mean due to increasing profitability. The current dividend yield of 1.7% is less than the 10-year average and median of 2.1%. The stock has traded in the past at a PE ratio below that of the S&P 500's average but investors have bid up the stock price as results have improved.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2023**
Payout	17.2%	18.9%	19.4%	19.9%	25.0%	24.6%	31.7%	75.6%	34.1%	31.7%	***32.6%***	***30.0%***

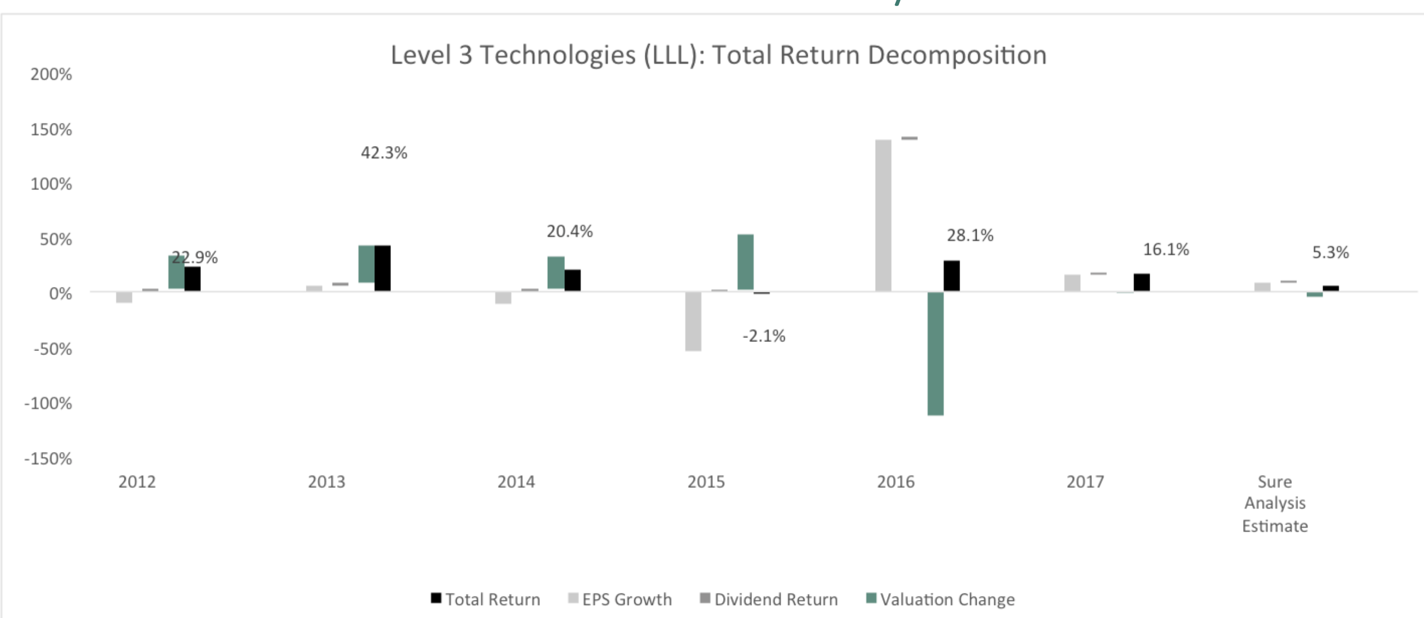
As a large defense contractor L3 has competitive advantages related to defense contracting, which often require knowledge of acquisition regulations and accounting standards particularly for large programs. The company develops and manufactures complex and bespoke systems for the DoD requiring a skilled work force with security clearances that is not easily replicated. Furthermore, L3 has built long-term relationships with both the DoD and prime contractors.

L3's capital structure is reasonable with total and long-term debt of $3,320M and equity of $5,642M. The debt is offset by $662M in cash and interest coverage is approximately 6.2X indicating that the company can pay its obligations. The dividend is well covered with a payout ratio of 31.7% and has increased by $0.20 annually in the past decade. We expect this trend to continue and the payout ratio to be maintained at about 30% since L3 historically has conducted large share repurchases in lieu of large dividend increases.

Final Thoughts & Recommendation

We are forecasting 5.3% total annual return over the next five years comprised of 1.7% yield, 8.0% earnings growth, and -4.4% from multiple contraction. Despite the competitive advantages of defense contractors we currently view L3 as overvalued and the merger with Harris adds a certain degree of uncertainty and furthermore the dividend yield is below long-term averages. In our view investors should wait for a better entry point.

Total Return Breakdown by Year



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Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.

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Income Statement Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Revenue	14901	15615	13390	13154	13107	11420	10986	9231	9210	9573
Gross Profit	1559	1656	1485	1441	1308	1117	1012	862	957	1020
D&A Exp.	206	218	212	230	228	202	214	203	198	225
Operating Profit	1685	1656	1485	1441	1308	1117	1012	862	957	1020
Op. Margin	11.3%	10.6%	11.1%	11.0%	10.0%	9.8%	9.2%	9.3%	10.4%	10.7%
Net Profit	938	901	955	958	784	751	664	-240	710	677
Net Margin	6.3%	5.8%	7.1%	7.3%	6.0%	6.6%	6.0%	-2.6%	7.7%	7.1%
Free Cash Flow	1169	1221	1283	1297	1096	1059	968	930	831	878
Income Tax	494	475	428	296	360	264	227	132	171	102

Balance Sheet Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Total Assets	14484	14813	15451	15508	13800	14007	13715	12069	11865	12729
Cash & Equivalents	867	1016	607	764	349	500	442	207	363	662
Acc. Receivable	1226	1149	1299	1093	968	991	803	746	700	723
Inventories	259	239	303	317	358	366	288	333	330	389
Goodwill & Int.	8446	8567	9200	7780	8090	8081	6707	6480	6603	6907
Total Liabilities	8543	8153	8596	8784	8273	7951	8355	7640	7241	7578
Accounts Payable	602	464	463	395	505	535	346	297	419	531
Long-Term Debt	4493	4112	4137	4125	3629	3630	3939	3626	3325	3330
Total Equity	5858	6567	6764	6635	5451	5981	5285	4355	4553	5083
D/E Ratio	0.77	0.63	0.61	0.62	0.67	0.61	0.75	0.83	0.73	0.66

Profitability & Per Share Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Return on Assets	6.5%	6.2%	6.3%	6.2%	5.4%	5.4%	4.8%	-1.9%	5.9%	5.5%
Return on Equity	15.8%	14.5%	14.3%	14.3%	13.0%	13.1%	11.8%	-5.0%	15.9%	14.1%
ROIC	8.9%	8.5%	8.8%	8.8%	7.8%	8.0%	7.0%	-2.8%	8.9%	8.2%
Shares Out.	122.4	117.4	115.1	105.6	97.6	91.1	87.8	81.9	78.8	79.6
Revenue/Share	121.7	133.01	116.33	124.56	134.29	125.36	125.13	112.71	116.88	120.26
FCF/Share	9.55	10.40	11.15	12.28	11.23	11.62	11.03	11.36	10.55	11.03

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.