L3 Technologies (LLL)

Updated January 31st, 2019 by Prakash Kolli

Key Metrics

Current Price:	$197	**5 Year CAGR Estimate:**	4.4%	**Volatility Percentile:**	28.8%
Fair Value Price:	$151	**5 Year Growth Estimate:**	8.0%	**Momentum Percentile:**	43.2%
% Fair Value:	121%	**5 Year Valuation Multiple Estimate:**	-5.2%	**Growth Percentile:**	73.5%
Dividend Yield:	1.6%	**5 Year Price Target**	$222	**Valuation Percentile:**	12.8%
Dividend Risk Score:	B	**Retirement Suitability Score:**	C	**Total Return Percentile:**	14.7%

Overview & Current Events

L3 Technologies (LLL) is a leading provider of defense communication and electronics systems that was formed in 1997. Today the company generates 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 another solid quarter for Q4 2018 on January 29, 2018. This is the fifth straight quarter that L3 has beaten revenue and earnings estimates. For Q4 2018, net sales increased to $2.7B, a 7% increase from Q4 2017 but earnings-per-share decreased -15% to $2.83 on year-over-year basis due to higher effective income tax rate. In Q4 2017 the company had a tax benefit of -19.9%. On quarterly year-over-year basis L3 exhibited improved profitability with a 50 bps improvement in operating margins to 10.9% and FCF increased 92% to $664M. The company's Intelligence, Surveillance, and Reconnaissance (ISR) Systems business segment continues to produce excellent results with a second consecutive quarter of double-digit sales growth (+14%) and operating margin improvements (+180 bps) on a year-over-year basis. However, the Communications & Networked Systems (C&NS) business segment continued to face headwinds with sales and operating margin declines.

From a full year perspective, L3 increased net sales 7% to $10.2B and operating income 9% to $1.12B YoY basis. Diluted earnings-per-share increased 6% YoY basis to $10.05. We expect this good performance to continue in 2019 as L3's order backlog has increased to $11,581M at the end of 2018 with ISR Systems (+19%) and Electronic Systems (+20%) leading the way. In this regard, for 2019 the company guided for 5% higher sales, a 120 bps increase in operating margin, and 12% increase in FCF. This does not include any cost or revenue synergies from its impending merger with Harris Corporation.

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	***$10.05***	***$14.77***
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	***79.6***	***68.4***

L3 has grown EPS since 2015 and saw a 6% increase in 2018. The bottom line is being driven by organic growth, tax cut benefits, improving profitability, and previous share buybacks. But share buybacks have recently slowed indicating that revenue growth due to increasing Department of Defense spending and tax cut benefits are primary EPS growth drivers. We forecast 8% annual EPS growth for the next five years due to higher expected defense spending 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	***19.6***	***15.0***
Avg. Yld.	1.2%	1.9%	2.0%	2.4%	2.8%	2.5%	2.1%	2.2%	2.0%	1.7%	***1.6%***	***1.6%***

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L3's current PE ratio of 19.6 using 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 1.6% 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 and also due to the expected merger with Harris. We have adjusted our current faire value price upward to $163 due to better than expected Q4 2018 results and our 5-year price target has also increased $222.

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%	***31.8%***	***32.0%***

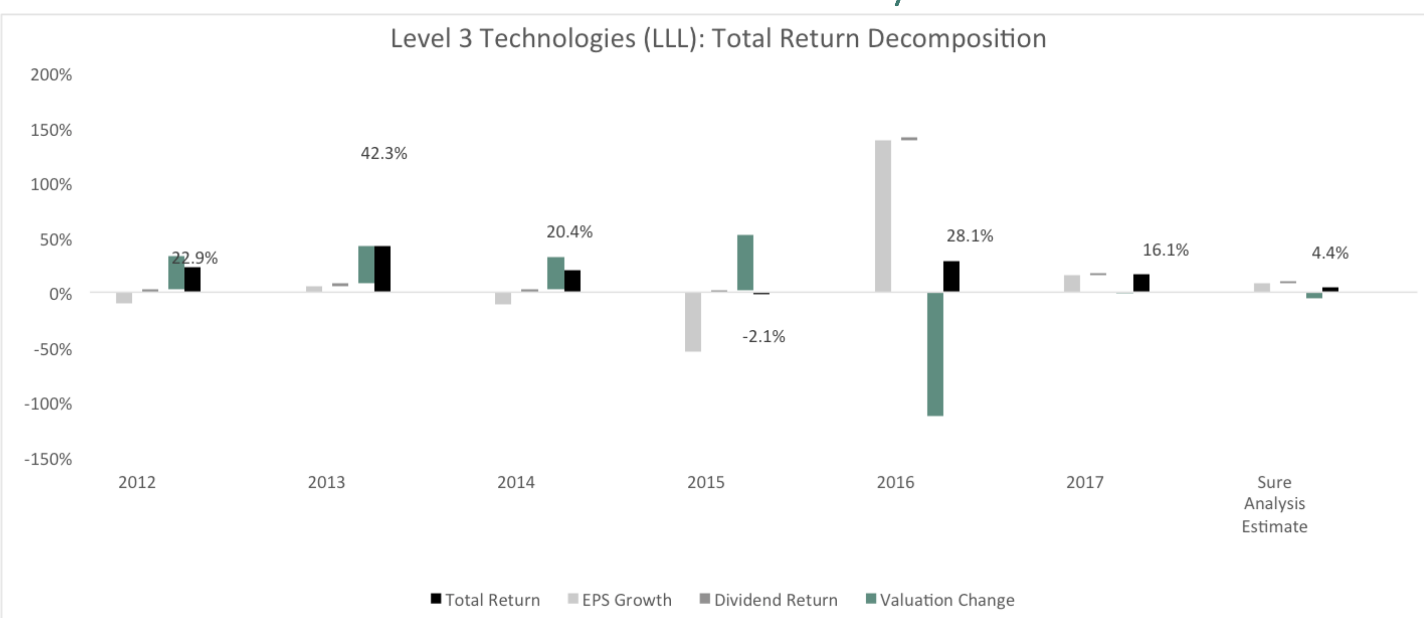
As a large defense contractor L3 has competitive advantages related to defense contracting, which often require knowledge of acquisition regulations and accounting standards particularly for large programs. The company develops and manufactures complex and bespoke systems for the DoD requiring a skilled 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 $3,321M and equity of $5,904M. The debt is offset by $1,066M in cash and interest coverage is approximately 6.4X indicating that the company can pay its obligations. The dividend is well covered and we expect the payout ratio to be maintained at about 32%.

Final Thoughts & Recommendation

We are forecasting 4.4% total annual return over the next five years comprised of 1.6% yield, 8.0% earnings growth, and -5.2% from multiple contraction. Despite the improving operational performance, we currently view L3 as overvalued and the merger with Harris adds a certain degree of uncertainty. Although we have adjusted our current price and 5-year price target upwards the recent surge in stock price limits investment appeal here. In fact, our total annual return estimate has decreased since our last report. In our view investors should wait for a better entry point.

Total Return Breakdown by Year



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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.