L3 Technologies (LLL)

Updated May 10th, 2019 by Prakash Kolli

Key Metrics

Current Price:	$235	**5 Year CAGR Estimate:**	5.9%	**Volatility Percentile:**	36.3%
Fair Value Price:	$177	**5 Year Growth Estimate:**	10.0 %	**Momentum Percentile:**	81.0%
% Fair Value:	133%	**5 Year Valuation Multiple Estimate:**	-5.6%	**Growth Percentile:**	91.2%
Dividend Yield:	1.5%	**5 Year Price Target**	$285	**Valuation Percentile:**	13.0%
Dividend Risk Score:	A	**Retirement Suitability Score:**	C	**Total Return Percentile:**	27.9%

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 annual revenue of ~$11B 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 reports three business segments that are the Intelligence, Surveillance, and Reconnaissance (ISR) Systems, Communications & Networked Systems (C&NS) and Electronic Systems. The company's market cap is ~$18.7B.

L3 Technologies reported another excellent quarter for Q1 2019 on May 1, 2019. This is the sixth straight quarter that L3 has beaten revenue and earnings estimates. Net sales increased 14% to $2.7B on a comparable quarter basis. Diluted earnings per share increased 16% to $2.17 on a year-over-year basis. Operating margins increased 90 bps to 11.5%. The effective income tax rate for the 2019 first quarter increased to 14.2% from 11.1% for the 2018 first quarter. In this quarter, the Intelligence, Surveillance, and Reconnaissance (ISR) Systems business segment continued to produce excellent results with a third consecutive quarter of double-digit sales growth (+23%) to $1,253M. In addition, operating margin improved 120 bps to 10.4% on year-over-year basis. The Communications & Networked Systems (C&NS) business segment exhibited a turn around with a 11% increase in sales to $785M. Operating margins improved 160 bps to 10.7%. The lagging business segment was Electronic Systems with only a 2% increase in sales to $662M. This segment's operating margins increased 20 bps to 14.7% on year-over-year basis.

The impending merger with Harris Corporation remains on track to close in mid-2019 pending regulatory approvals. Shareholders of L3 Technologies will receive 1.30 shares of Harris Corporation for each of their own shares outstanding. This will create the sixth largest defense contractor with a combined revenue of ~$16B and a market capitalization of over $32B. The merged company is expected to have ~$500M in cost synergies and is targeting $3B in free cash flow by year 3. The combined entity will have increased scale and stronger presence in defense ISR, communications, and electronics systems allowing L3 Harris to more effectively compete for defense prime contracts. This should serve as a catalyst for future growth.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
EPS	$7.39	$8.25	$9.03	$8.12	$8.54	$7.56	$3.44	$8.21	$9.46	$10.05	***$11.06***	***$17.80***
DPS	$1.40	$1.60	$1.80	$2.00	$2.20	$2.40	$2.60	$2.80	$3.00	$3.20	***$3.40***	***$4.40***
Shares	115.4	108.6	98.9	90.4	85.6	82.5	78.1	77.2	77.9	78.8	***77.2***	***69.8***

L3 has grown EPS since 2015 and saw over a 6% increase in 2018. The bottom line is being driven by organic growth, higher margins, and share buybacks. But share buybacks have recently slowed indicating that revenue growth due to increasing Department of Defense spending is the primary EPS growth driver. We have increased our estimate for average EPS growth and now forecast 10% average annual EPS growth for the next five years due to higher expected defense spending and benefits from the impending merger related to revenue and cost synergies.

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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Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	10.1	9.7	8.2	8.8	10.4	15.4	34.6	16.8	18.4	20.0	***19.8***	***16.0***
Avg. Yld.	1.9%	2.0%	2.4%	2.8%	2.5%	2.1%	2.2%	2.0%	1.7%	1.6%	***1.5%***	***1.6%***

L3's current PE ratio of 19.8 using expected 2019 EPS is greater than its 10-year average of 15.2 suggesting that the stock is overvalued on this metric. We believe that the PE ratio will decrease to 16.0 over the next 5-years, a value slightly greater than its long-term mean due to increasing profitability and scale from the merger. The current dividend yield of 1.5% 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 $177 due to better than expected results. Accordingly, our 5-year price target has also increased $285.

Safety, Quality, Competitive Advantage, & Recession Resiliency

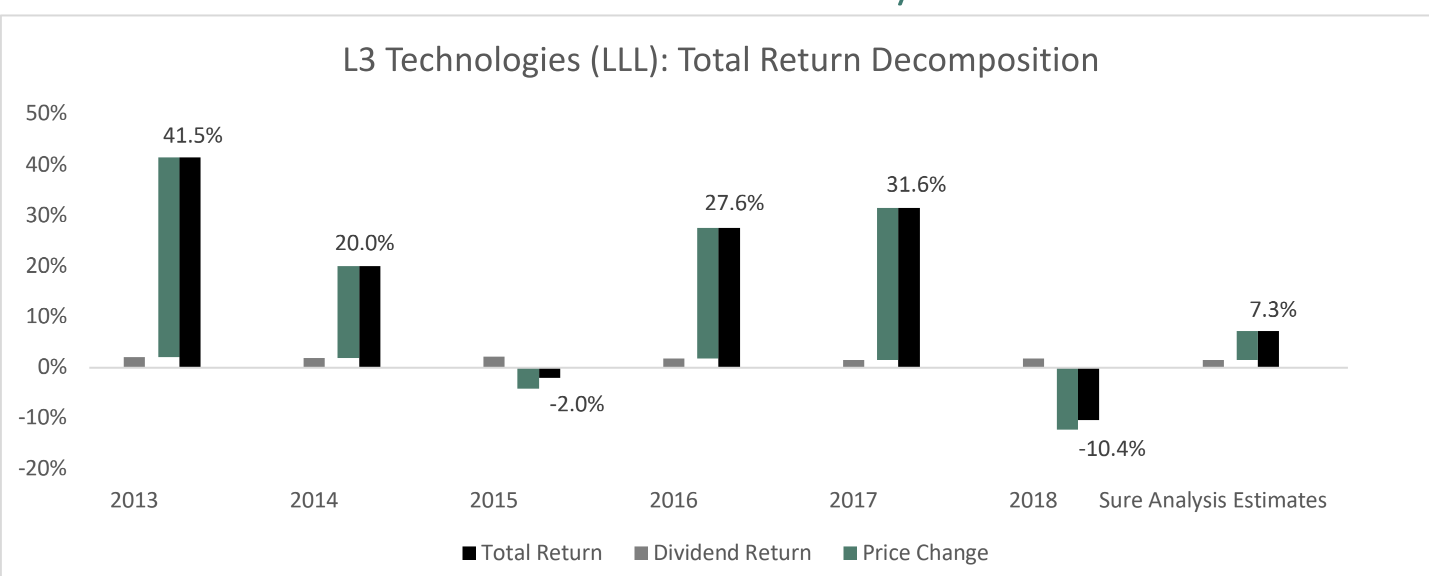
Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2023
Payout	18.9%	19.4%	19.9%	25.0%	24.6%	31.7%	75.6%	34.1%	31.7%	31.8%	***30.8%***	***25.9%***

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. These attributes make it recession resistant and in fact the company increased EPS during the Great Recession.

Final Thoughts & Recommendation

We are forecasting 7.3% total annual return over the next five years comprised of 1.5% yield, 10.0% earnings growth, and -4.2% from multiple contraction. Despite the improving operational performance and profitability, we currently view L3 Technologies as overvalued. Although we have adjusted our fair value and 5-year price target upwards the recent surge in stock price limits investment appeal here. We view this stock as a hold for current investors.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	15615	13390	13154	13107	11420	10986	9231	9210	9573	10244
Gross Profit	1656	1485	1441	1308	1117	1012	862	2245	2551	2707
Gross Margin	10.6%	11.1%	11.0%	10.0%	9.8%	9.2%	9.3%	24.4%	26.6%	26.4%
SG&A Exp.	N/A	N/A	N/A	N/A	N/A	N/A	N/A	1287	1520	1601
D&A Exp.	218	212	230	228	202	214	203	198	225	241
Operating Profit	1656	1485	1441	1308	1117	1012	862	958	1031	1106
Op. Margin	10.6%	11.1%	11.0%	10.0%	9.8%	9.2%	9.3%	10.4%	10.8%	10.8%
Net Profit	901	955	958	784	751	664	-240	710	677	1005
Net Margin	5.8%	7.1%	7.3%	6.0%	6.6%	6.0%	-2.6%	7.7%	7.1%	9.8%
Free Cash Flow	1221	1283	1297	1096	1059	968	930	831	878	800
Income Tax	475	428	296	360	264	227	132	171	102	103

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets	14813	15451	15508	13800	14007	13715	12069	11865	12729	13518
Cash & Equivalents	1016	607	764	349	500	442	207	363	662	1066
Acc. Receivable	1149	1299	1093	968	991	803	746	700	723	919
Inventories	239	303	317	358	366	288	333	330	389	879
Goodwill & Int.	8567	9200	7780	8090	8081	6707	6480	6603	6907	7190
Total Liabilities	8153	8596	8784	8273	7951	8355	7640	7241	7578	7611
Accounts Payable	464	463	395	505	535	346	297	419	531	699
Long-Term Debt	4112	4137	4125	3629	3630	3939	3626	3325	3330	3321
Total Equity	6567	6764	6635	5451	5981	5285	4355	4553	5083	5839
D/E Ratio	0.63	0.61	0.62	0.67	0.61	0.75	0.83	0.73	0.66	0.57

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets	6.2%	6.3%	6.2%	5.4%	5.4%	4.8%	-1.9%	5.9%	5.5%	7.7%
Return on Equity	14.5%	14.3%	14.3%	13.0%	13.1%	11.8%	-5.0%	15.9%	14.1%	18.4%
ROIC	8.5%	8.8%	8.8%	7.8%	8.0%	7.0%	-2.8%	8.9%	8.2%	11.4%
Shares Out.	115.4	108.6	98.9	90.4	85.6	82.5	78.1	77.2	77.9	78.8
Revenue/Share	133.0	116.33	124.56	134.29	125.36	125.13	112.71	116.88	120.26	128.69
FCF/Share	10.40	11.15	12.28	11.23	11.62	11.03	11.36	10.55	11.03	10.05

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