

Contractor Survival Tactics: Raytheon Focuses on High-Growth Markets, Foreign Sales To Offset Cuts

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As part of our efforts to keep tabs on the evolving federal marketplace, we are constantly evaluating how various vendors are performing, and analyzing the steps these contractors are taking to achieve success going forward.

In this week's blog, we turn the spotlight on defense contracting giant Raytheon Corp., which has been focusing its efforts on high-growth markets like ISR and cybersecurity, while expanding its foreign military sales to offset upcoming federal budget cuts.

Based in Waltham, Mass., Raytheon is among the largest aerospace and defense firms in the U.S., with a diversified line of military products, including missiles, radars, sensors, surveillance and reconnaissance equipment, communication and information systems, naval systems, air traffic control systems, and technical services.

In 2011, Raytheon's total net sales to the U.S. Government, excluding foreign military sales, were \$18.4 billion, representing 74% of the company's overall net sales. Foreign military sales (through the U.S. Government) were approximately \$3 billion. Raytheon's primary U.S. Government customer is the Department of Defense (DoD); other key federal customers include Intelligence Community agencies, the Departments of Homeland Security, Justice, State and Energy, NASA and the FAA.

FIA Perspective:

Raytheon making acquisitions in high-growth markets to expand capabilities. In 2011, Raytheon acquired California-based Applied Signal Technology Inc. (for \$500 million) to broaden its capabilities in Command, Control, Communication and Intelligence (C3I). Raytheon said the acquisition is part of its strategy to "extend and enhance its Space and Airborne Systems (SAS) offerings related to certain classified and DoD markets." Raytheon's C3I systems provide integrated real-time support to decision-makers on and off the battlefield, transforming raw data into actionable intelligence. Raytheon's C3I capabilities include situational awareness, persistent surveillance, communications, mission planning, battle management command and control, intelligence and analysis, and integrated ground solutions. As part of its strategy, Raytheon said it's "continuing to grow its market presence in C3I and expand its knowledge management and discovery capabilities."

In 2011, Raytheon also acquired Henggeler Computer Consultants Inc. and Pikewerks Corp. to enhance its cybersecurity and information assurance capabilities at Intelligence and Information Systems (IIS). Pikewerks specializes in cybersecurity, software protection, anti-tamper, information operations, data protection and forensics, while Henggeler focuses on cybersecurity, enterprise architecture, analytics, software, and cloud-based solutions. In its annual report, Raytheon said it "continues to enhance its capabilities in the cybersecurity market as well as leverage the capabilities of the ten cyber acquisitions it has made since 2007." Raytheon said it's focusing on providing cyber capabilities to the Intelligence, DoD and DHS markets, as well as embedding information assurance capabilities in its products and IT infrastructure.

In 2011, Raytheon also acquired key business assets of Ktech Corp., expanding the company's capabilities and opportunities in the non-kinetic effects markets. Located in Albuquerque, N.M., Ktech is a leader in pulsed power systems engineering. Ktech's compact pulsed power systems, combined with its high efficiency magnetron technology, will enable increased integration of directed energy weapons on combat platforms.

While Raytheon hasn't made any acquisitions thus far in 2012, M&A will continue to be a key component of the company's overall growth strategy moving forward. At the end of the latest quarter, Raytheon had about \$2.5 billion in cash on hand to put towards future acquisitions.

Raytheon aiming to grow international business via foreign military sales. Raytheon believes demand is growing for solutions in air and missile defense, homeland security, air traffic management, precision engagement, naval systems integration, and intelligence, surveillance and reconnaissance (ISR). In addition, as coalition forces increasingly integrate military operations worldwide, Raytheon believes that its capabilities in network-enabled operations will continue to be "a key discriminator in these markets."

In 2011, Raytheon's international sales, including foreign military sales through the U.S. Government, totaled \$6.2 billion, compared with \$5.8 billion in 2010. For 2011, the company's international bookings checked-in at \$7.7 billion, rising substantially from \$4.4 billion in 2010.

On its second quarter earnings call, Raytheon Chairman and CEO Bill Swanson said he's counting on the company's variety of products and services as well as international business to weather future U.S. defense spending cuts. Swanson highlighted that foreign orders may contribute as much as 30% to Raytheon's bookings for 2012, up from 25% at the end of the first quarter. He expects future orders for missile defense systems, precision missiles, command control and communications systems and air-traffic control radar from several countries in the Middle East, while noting that Turkey, Kuwait, Oman, Saudi Arabia and the United Arab Emirates could be potential customers.

Raytheon posts solid financials in 2Q. In the latest second quarter, Raytheon's net income jumped to \$471 million, or \$1.41 per share, compared with \$438 million, or \$1.20 per share, in the prior-year period. At the same time, Raytheon's revenue slipped 3.4% to \$5.99 billion, compared with \$6.2 billion in the previous year's comparable quarter. At the end of the latest quarter, Raytheon's total backlog

was \$33.9 billion, of which \$23.1 billion was funded.

Looking ahead, Raytheon raised its full-year profit forecast from continuing operations to \$5.15 to \$5.30 a share, compared with an earlier forecast of \$5 to \$5.15 a share. For 2012, Raytheon maintained its sales guidance in the range of \$24.5 billion to \$25 billion.

Raytheon “well-positioned” for future DoD opportunities. In January 2012, the DoD issued strategic guidance on the U.S. defense priorities for the next ten years in light of the geopolitical environment and U.S. Government finances. The DoD guidance identified the primary missions of the U.S. armed forces and the capabilities expected to be critical to future success, including ISR, missile defense and cybersecurity. Although the actual impact of implementation of the strategic guidance on the DoD budget and Raytheon’s programs is uncertain at present, the company believes it’s “well positioned” to support many of these critical capabilities going forward.

In its annual report, Raytheon noted that it’s currently involved in over 15,000 contracts, with no single contract accounting for more than 5% of its total net sales for 2011. The company also believes that its “diverse portfolio of programs and capabilities is well suited to the changing defense environment.”

Our Take:

Overall, we believe Raytheon is a well-diversified defense contractor with history of strong order bookings and order backlog. The company also has a solid balance sheet, with growing cash flow and operational improvements.

In the future, we expect Raytheon’s growth to be driven by its focus on ISR- and missile-related technologies, cybersecurity, and foreign military sales. However, with potential reductions to the U.S. defense budget on the horizon, and numerous high-cost programs at risk, it’s difficult to predict if Raytheon could see future order reductions or cancellations moving forward.

Despite the potential risks, we like that Raytheon has a clearly-defined growth strategy, and believe that its focus and investments in key high-growth markets (such as ISR and cybersecurity) will align well with future defense priorities, which should allow the company to remain competitive and achieve success in today’s challenging federal market.