

October, 13, 2017

## Leidos Holdings, Inc.: LDOS

Ryan Fuchs

**Sector:** Information Technology

**Industry:** IT Services

**Current Price:** \$62.78

**Target Price:** \$81.60

**Company Description:** Leidos Holdings, Inc. is a global leader in the integration and application of information technology, engineering, and science to solve the customers' most demanding challenges. Leidos provides technology and engineering solutions in the defense, intelligence, homeland security, civil, and health markets in the United States and internationally.

### BUY

Current Price:	\$62.78
Target Price:	\$81.60
Market Cap:	9.49B
PE Ratio:	20.96
EBITDA Margin:	10.03%
ROIC:	9.9%
Book-To-Bill:	1.0
Volume:	1,066,661

### Catalysts:

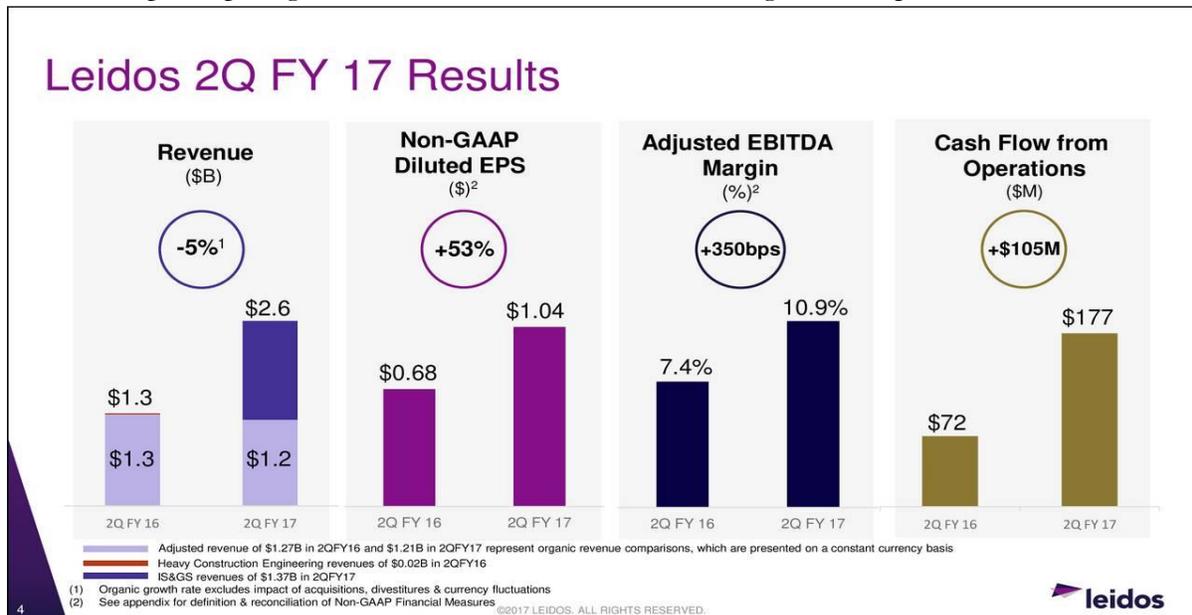
- Short Term(within the year): Increased profitability from defense segment driven by increasing global tensions
- Mid Term(1-2 years): Participation in FY 2018's increased budget proposal
- Long Term(3+): Locked in forward contracts in various segments

**Thesis:** Leidos Holdings, Inc. is a best-in-class IT services provider. The company's ability to provide services in many different industries creates value through their large customer base. With customer relationships going back over 40 years, Leidos is a reliable company with very little threat of substitutes. With the acquisition of Lockheed Martin's Information Systems and Global Solutions business, Leidos is growing faster than ever. This stock provides short-term growth from its market share and profitability in the booming defense industry. Long-term growth for Leidos is derived from its ability to lock in major forward contracts with organizations as large as the US Social Security. We must capitalize on this buy as Leidos will continue to dominate its industry.



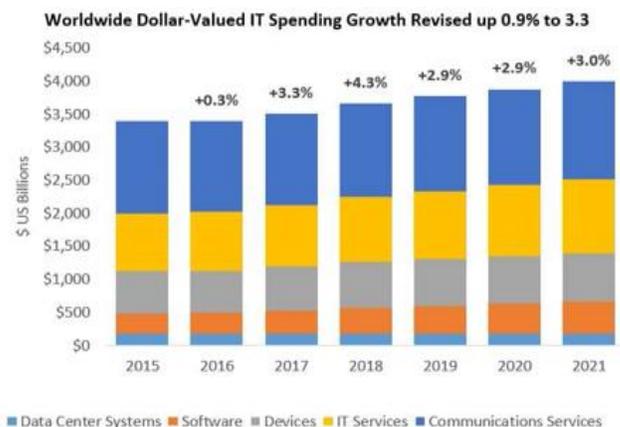
## Earnings Performance:

Revenues for the 2<sup>nd</sup> quarter of 2017 were \$2.57 billion, compared to \$1.29 billion in the prior year quarter. This increase was primarily due to \$1.37 billion of revenue generated from the Information Systems and Global Solutions (IS&GS) business acquired from Lockheed Martin during the third quarter of FY 2016. Operating income for the 2<sup>nd</sup> quarter of 2017 was \$166 million, compared to \$75 million in the prior year quarter. Operating margin increased to 6.5% from 5.8% in the prior year quarter. This quarter's results include \$67 million of amortization of intangible assets, \$16 million of acquisition and integration costs, \$9 million of amortization of equity method investments and \$6 million of restructuring charges related to the acquisition of the IS&GS Business. Non-GAAP diluted EPS for the quarter was \$1.04, compared to \$0.68 in the prior year quarter. The weighted average diluted share count for the quarter was 153 million, up from 74 million in the prior year quarter. This increase was primarily due to the issuance of approximately 77 million shares of Leidos common stock to participating Lockheed Martin stockholders relating to the acquisition of the IS&GS business.



## Industry Outlook:

Information Technology is a growing industry from the business to consumer level. As shown in the chart below, IT spending is projected to grow 2.9-4.3% annually for the next 5 years. The need for IT scans across various industries. Innovation is the main driver of the technology industry. Digital is innovating the entire technology industry. As digital transforms technology products and services, the industry is leaning more towards cloud. Digital is effecting every industry. Because digital effects such a large scale, the best way to create value in the IT industry is now by forming partnerships and collaborating with a network of those partners. Leidos has done so by merger with Lockheed Martin. This deal combines Leidos' airport engineering

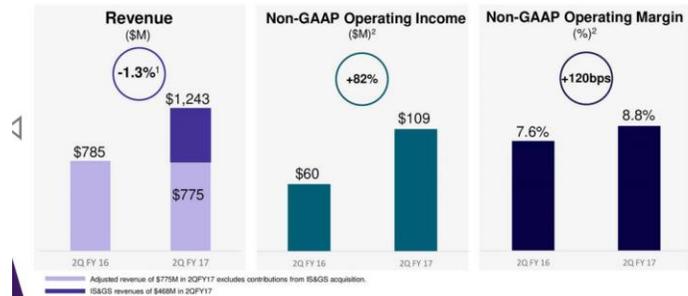


and security systems with Lockheed’s planning tool for managing traffic flow, airport modernization, and air traffic management.

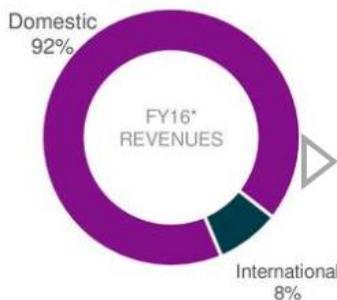
## Defense Solutions Segment:

Leidos defense and intelligence group provides solutions and services including enterprise and mission IT, large-scale intelligence systems, command and control, geospatial and data analytics, cybersecurity, logistics, training, and intelligence analysis and operations support. Leidos defense solutions segment revenues for the 2<sup>nd</sup> quarter of 2017 were \$1,243 million increased 58% from the prior year quarter. The revenue

### Defense Solutions Segment



growth was a result of the acquired IS&GS business and growth in their airborne programs. The IS&GS business allows Leidos to strengthen their market share in the defense industry. The business will add large complex IT system implementation and both federal and international IT solutions to Leidos’ portfolio. As increased global tensions lead to increase in demand for defense, the industry’s revenues are forecasted to grow at 3.2% this year in the US. Further growth will be driven by President Trump’s emphasis on strengthening the US military. This will make the defense solutions segment even more profitable, as 92% of FY 2016’s revenue came in the US. On March 16, 2017, President Trump unveiled the Pentagon’s fiscal 2018 budget proposal. This proposal highlighted a \$54 billion increase from FY 2017. With 40+ year relationships with the Army, Navy, Department of Defense, and Federal Aviation Administration, the increased budget will provide more opportunities for Leidos’ services. The company’s ability to lock in defense related forward contracts with organization such as the Defense Intelligence Agency, Defense Threat Reduction Agency, and US Army provides long-term growth for the firm.



## Ownership:

Currently 78.37% of Leidos Holdings is owned institutionally with 83.62% coming from Investment Advisors and 9.19% from hedge funds. Blackrock stands as the largest owner with roughly 12,650,322 shares held. Within that, Blackrock’s position has increased 11.26% which seems to be promising for Leidos as the hedge fund believes there is still growth. Throughout the last 4 months, short interest has decreased 1%. With the decrease in short interest, it is likely that Blackrock’s interest is long. A positive change of 3.37% in institutional ownership is also good sign for Leidos.

Institutional - Based on Current Filings				Date	Short Interest (%)	Short Interest (Shares in Mil)
51) Institutional	10/08/17	Curr	Change			
11) % of Shares Held	78.37	78.40	+0.03%	September 29, 2017	1.85	2.56
12) % of Float Held	78.93	78.95	+0.02%	September 15, 2017	2.42	3.35
13) # of Institutions	588	587	-0.17%	August 31, 2017	2.53	3.49
14) # of Buyers	208	210	+0.96%	August 15, 2017	1.95	2.69
15) # of Sellers	158	155	-1.90%	July 31, 2017	2.02	2.78
16) # of New Buyers	90	93	+3.33%	July 14, 2017	2.15	2.98
17) # of Selloffs	69	71	+2.90%	June 30, 2017	2.44	3.37
18) % Chg in Inst Positions	+3.36	+3.37	+0.01%	June 15, 2017	2.85	3.94

## Capital Allocation:

Behind CR Magazine's 2017 *Responsible CEO of the Year*, Roger Krone, Leidos management has effectively created value with their capital allocation. In the 2<sup>nd</sup> quarter of 2017, Leidos generated \$177 million in cash flows from operations, a \$105 million increase from the prior year quarter. The higher operating net cash inflows were the result of timing of billing and collections activities. Net cash flows used in financing activities of continuing operations for the quarter were \$112 million compared to \$30 million in the prior year quarter. The higher financing cash outflows were primarily due to repayments of long-term debt. Leidos is currently in the process of delevering through a \$275 million dollar accelerated repayment of acquisition debt. The firm currently has a Debt/EBITDA of 3.36x, right at the industry average of 3.32x. Through this delevering, they are targeting a Debt/EBITDA of 3.0x. Below displays the impact the delevering will have on the WACC: By lowering the cost of debt 0.5% and the D/E ratio by .05, the WACC decreases by .03%.

## BEFORE DELEVER

WACC = $(1/[1+D/E]) \times Ke + (D/E/[1+D/E]) \times Kd \times (1-T)$						
WACC		Ke (Kd+Country Risk)		Kd		
	History	LTM		History	LTM	
LDOS	9.7%	10.1%	LDOS	11.6%	12.2%	
Competitors	10.3%	8.7%	Competitors	11.1%	10.2%	
Target	10.1%		Target	12.2%		
				Country Risk	5.69%	
				Capitalization (Debt/Equity)		
				History	LTM	
				LDOS	0.36	0.41
				Competitors	0.25	0.36
				Target	0.41	

## AFTER DELEVER

$$WACC = (1/[1+D/E]) \times Ke + (D/E/[1+D/E]) \times Kd \times (1-T)$$

	Kd	
	History	LTM
LDOS	6.0%	6.5%
Competitors	6.0%	4.6%
<b>Target</b>	<b>6%</b>	

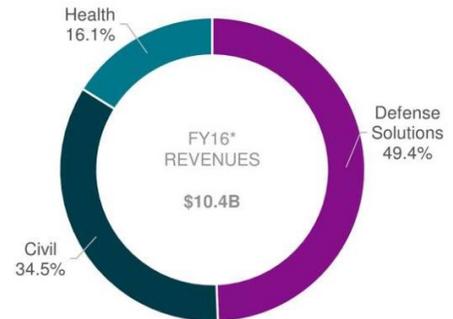
WACC	History	LTM
	LDOS	9.7%
Competitors	10.3%	8.7%
<b>Target</b>	<b>9.8%</b>	

	Ke (Kd+Country Risk)	
	History	LTM
LDOS	11.6%	12.2%
Competitors	11.1%	10.2%
<b>Target</b>	<b>11.6%</b>	

Country Risk	5.69%
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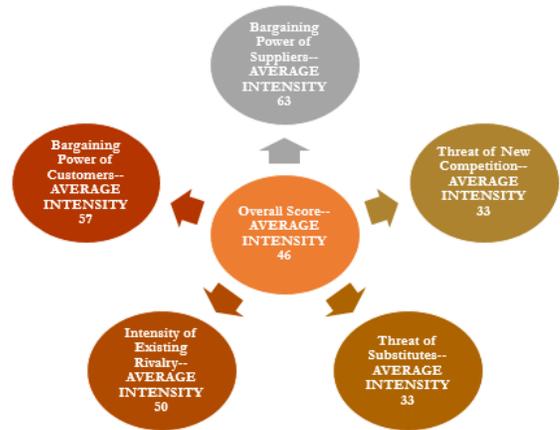
	Capitalization (Debt/Equity)	
	History	LTM
LDOS	0.36	0.41
Competitors	0.25	0.36
<b>Target</b>	<b>0.36</b>	

Another area Leidos management is focusing on is cash usage. The firm is targeting 100%+ cash efficiency. This will drive Leidos' 9.9% ROIC, which has room to grow as it is only slightly above the industry average of 9.66%. With the large amount of cash Leidos generates from operations, the firm will be able to invest their cash even during a delevering process. With excess cash, Leidos plans to repurchase shares. The returns derived from this increased cash usage will further expand their margins, another area that management has addressed. Leidos is particularly focusing on expanding their EBITDA margin, which increased 350 basis points in the 2<sup>nd</sup> quarter of 2017 from the prior year quarter. The increase in EBITDA margins will directly decrease their Debt/EBITDA, helping them efficiently reach their target 3.0x. The IS&GS business will also provide cost synergies to further expand the company's margins. The acquired business allows Leidos to offer cost-effective solutions to customers by adding large, complex IT system implementation. Leidos' diverse budgeting has also created value for the company. Management has been successful in their budgeting by putting the most money in their most profitable segment, defense solutions, but still allowing the other two segments to drive revenues. This is important because it eliminates non-systematic risk. In the event that a macro phenomenon hurts one segment of business, the company will still be able to drive revenues. This is what makes the acquisition of Lockheed Martin's IS&GS business so strategic. The IS&GS business' greatest strength is in civil agency, the segment where the business had the greatest impact on 2017's 2<sup>nd</sup> quarter revenues. IS&GS accounted for \$625 million of the civil segment's \$875 million in revenue for the quarter. These revenues were driven by IS&GS' ability to serve customers' needs across civil federal agencies. However, the IS&GS business still managed to significantly contribute to the health and defense segments as well. Management gave guidance of 3% revenue growth, 10%+ adjusted EBITDA margin, and 100% cash efficiency for 2018 & beyond.



## Large Customer Base:

Through the acquisition of the IS&GS business, Leidos has both strengthened and increased their customer base. The company's ability to sustain long-term relationships with customers eliminates the threat of substitutes (33/100 intensity on Porter 5 forces model). Net bookings totaled \$2.7 billion in quarter 2 of 2017. This gave Leidos a book-to-bill ratio of 1, which indicates a strong demand for Leidos' services. Most notable awards received in quarter 2 of 2017 were from the Defense Threat Reduction Agency and US Army. The DTRA awarded Leidos a contract to support their Cooperative Biological Engagement Program and Cooperative Threat Reduction Program through a worldwide Scientific and Technical Engagement Partnership program. This contract has a one-year base period of performance, four one-year options, and a total contract value of approximately \$170 million if all options are exercised. The US Army awarded Leidos a task order to provide program management solutions to the Department of Defense Biometrics program. The contract has a one-year base period of performance, four one-year options, and a total contract value of approximately \$132 million, if all options are exercised. From September 26, 2017- October 12, 2017, Leidos announced four more multi-year contracts. The most notable of these contracts was a 10 year contract providing IT services to US Social Security Agency's strategic plan. This contract has up to a 10-year period if all options are exercised and the contract ceiling totals \$2.3B. With all the hatred surrounding President Trump, this is a crucial service, which makes this contract monumental for the company. On October 12, 2017, Leidos was also awarded a contract by the National Geospatial-Intelligence Agency to provide IT assistance to the Agency's Information Technology Enterprise Management User Facing Services program. This contract has a five-year ordering period with a \$988 million ceiling. On October 3, 2017, Leidos received a \$25 million contract from the US Department of Energy Information Administration to provide energy consumption information for two complex surveys. This cost-plus-fixed-fee contract has a four year period. After the announcement of the contract, Leidos shares were up 0.17% after hours. Leidos' ability to frequently acquire significant long-term contracts demonstrates their dominance in their industry.



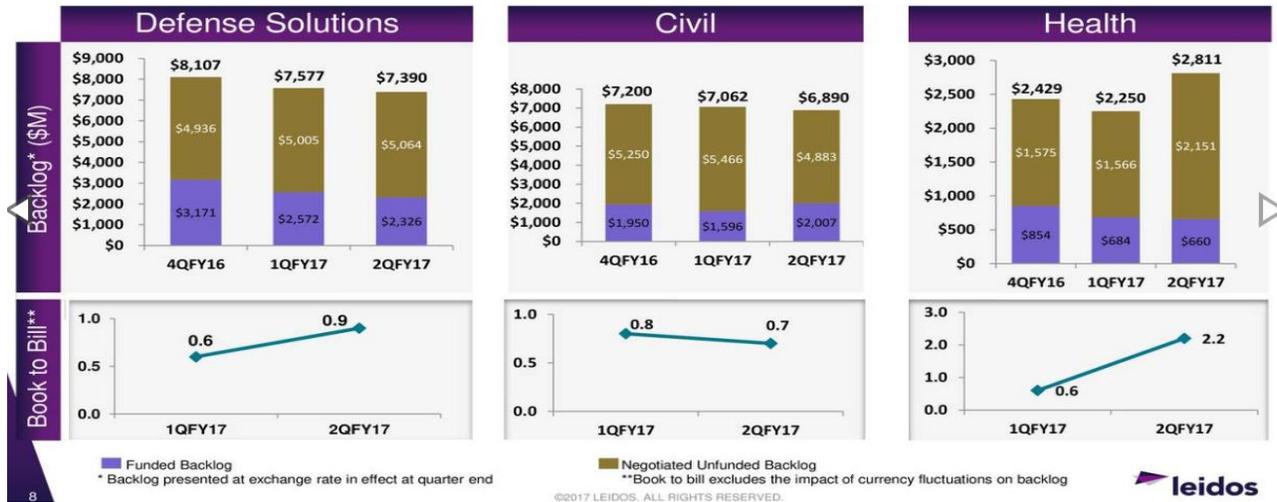
### LDOS: A TRUSTED LONG-TERM PARTNER

### Leidos + IS&GS

<b>40+ year RELATIONSHIPS</b>						
<b>30+ year RELATIONSHIPS</b>			CLASSIFIED	NATS	CLASSIFIED	
<b>20+ year RELATIONSHIPS</b>			CLASSIFIED	NATIONAL CANCER INSTITUTE	SOCIAL SECURITY ADMINISTRATION	Australian Government Department of Defence
<b>10+ year RELATIONSHIPS</b>				CLASSIFIED		

At the end of quarter 2 of 2017, Leidos' backlog of signed business orders totaled \$17.1 billion, of which \$5 billion was funded. The company's book to bill ratio of 1 shows their ability to process orders despite this large amount of backlog.

## Awards & Backlog



## Conclusion:

We must capitalize on this buy as Leidos will continue to dominate its industry. With locked in long-term forward contracts in place, the company will only continue growing. Through the IS&GS business integration into the company, there are still synergies coming in the future. President Trump's increased defense budget for FY 2018 provides opportunities for potential large-scale future contracts as Leidos has 40+ year relationships with major defense organizations. With an increasing book to bill ratio, the demand for Leidos' services will only continue rising. The company has all the signs of meeting or exceeding its guidance of 3% revenue growth. Leidos is a best-in-class IT service provider with both room and momentum to improve.

**Leidos Holdings, Inc.**  
**(LDOS)**

**CENTER FOR GLOBAL FINANCIAL STUDIES**

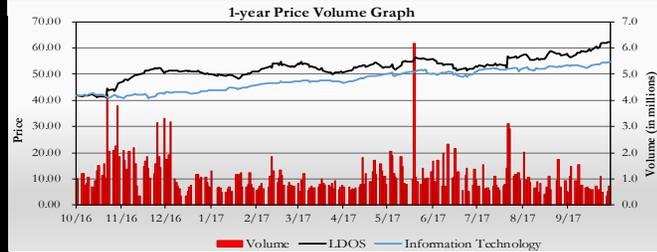
**BULLISH**

Analysis by RYAN  
10/13/2017

Current Price: **\$62.78**  
Dividend Yield: **2.6%**

Intrinsic Value: **\$74.83**  
Target Price: **\$83.56**

Target 1 year Return: 35.75%  
Probability of Price Increase: 94.5%

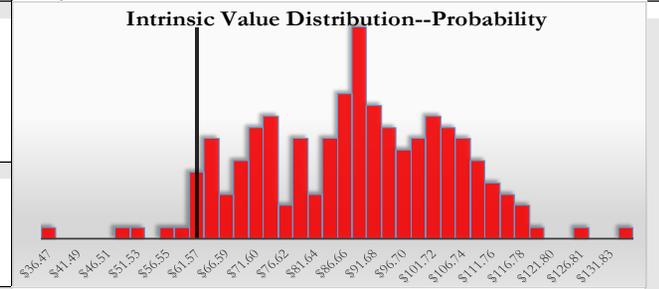


<p><b>Description</b></p> <p>Leidos Holdings, Inc., a science and technology company, provides technology and engineering solutions in the defense, intelligence, homeland security, civil, and health markets in the United States and internationally.</p>	
<p><b>General Information</b></p> <p>Sector: Information Technology Industry: IT Services Last Guidance: November 3, 2015 Next earnings date: November 2, 2017 Estimated Country Risk Premium: 5.69% Effective Tax rate: 24% Effective Operating Tax rate: 40%</p>	

Market Data	
Market Capitalization	\$9,423.35
Daily volume (mil)	0.22
Shares outstanding (mil)	151.21
Diluted shares outstanding (mil)	143.50
% shares held by institutions	84%
% shares held by investments Managers	65%
% shares held by hedge funds	6%
% shares held by insiders	0.41%
Short interest	1.69%
Days to cover short interest	2.88
52 week high	\$62.66
52-week low	\$40.96
Volatility	32.60%

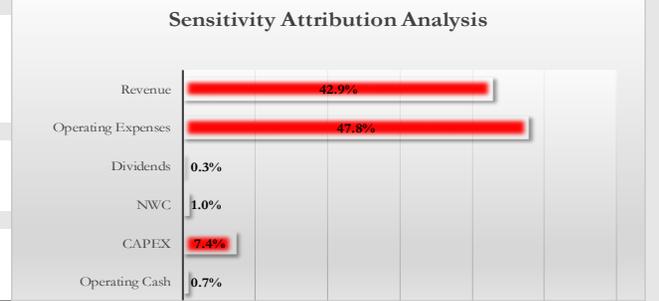
Past Earning Surprises		
Quarter ending	Revenue	EBITDA
7/1/2016	-1.53%	-6.54%
9/30/2016	-2.61%	1.08%
12/30/2016	-1.72%	-10.95%
3/31/2017	-1.19%	-20.51%
6/30/2017	-1.19%	-11.58%
Mean	-1.65%	-9.70%
Standard error	0.3%	3.5%

Peers	
Booz Allen Hamilton Holding Corporation	
Cognizant Technology Solutions Corporation	
DXC Technology Company	
Science Applications International Corporation	
CACI International Inc	
Unisys Corporation	

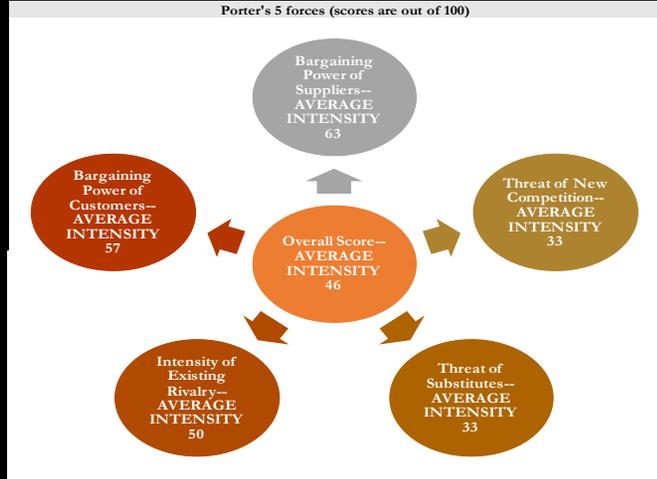


Management		Position	
Krone, Roger	Chairman & CEO		
Reagan, James	Chief Financial Officer and		
Scholl, Jonathan	President of Health Group		
Reardon, Timothy	President of Defense & Intel		
Chadha, Ranjit	Chief Accounting Officer, Se		
Fratamico, John	Chief Technology Officer and		

Total compensations growth		Total return to shareholders	
19.3% per annum over 2y		13.8% per annum over 2y	
N/M		-6.83% per annum over 1y	
N/M		-6.83% per annum over 1y	
N/M		-6.83% per annum over 1y	
N/M		N/M	
N/M		N/M	



Profitability		LDOS (LTM)		LDOS (5 years historical average)		Peers' Median (LTM)	
Return on Capital (GAAP)	11.4%	14.61%	18.41%	14.61%	18.41%	13.8%	18.41%
Operating Margin	7%	5.6%	6.55%	5.6%	6.55%	6.5%	6.55%
Revenue/Capital (GAAP)	1.58	2.63	2.81	2.63	2.81	2.81	2.81
ROE (GAAP)	10.2%	23.5%	22.4%	23.5%	22.4%	22.4%	22.4%
Net margin	3.3%	4.3%	7.3%	4.3%	7.3%	7.3%	7.3%
Revenue/Book Value (GAAP)	3.05	5.46	3.06	5.46	3.06	3.06	3.06



Period		Revenue Growth Forecast		NO PAT Margin Forecast		Revenue to Capital Forecast	
Base Year		83%		4.8%		1.20	
6/30/2018		20%		1.3%		1.33	
6/30/2019		3%		1.9%		1.33	
6/30/2020		5%		2.4%		1.38	
6/30/2021		6%		2.8%		1.43	
6/30/2022		4%		3.0%		1.44	
6/30/2023		4%		3.3%		1.45	
6/30/2024		4%		7.6%		1.46	
6/30/2025		4%		8.5%		1.38	
6/30/2026		4%		8.6%		1.30	
6/30/2027		-49%		7.5%		0.60	
Continuing Period		4%		7.9%		0.60	

Period		Return on Capital Forecast		WACC Forecast		Price per share Forecast	
Base Year		5.8%		8.4%		\$75.82	
6/30/2018		1.7%		8.4%		\$84.89	
6/30/2019		2.5%		8.0%		\$92.72	
6/30/2020		3.2%		8.1%		\$100.88	
6/30/2021		4.0%		7.8%		\$108.78	
6/30/2022		4.4%		7.8%		\$116.74	
6/30/2023		4.8%		7.5%		\$124.47	
6/30/2024		11.1%		7.5%		\$132.20	
6/30/2025		11.8%		7.2%		\$139.53	
6/30/2026		11.2%		7.2%		\$146.71	
6/30/2027		4.5%		6.9%		\$154.33	
Continuing Period		4.8%		6.9%			

