INVESTOR'S BUSINESS DAILY

TUESDAY, NOVEMBER 1, 2005

COMPANIES IN THE NEWS

While Military Cuts Loom, L-3 Appears Well Protected

BY DAVE EISENSTADT
INVESTOR'S BUSINESS DAILY

As much of the defense industry braces for multibillion dollar cuts in military spending, L-3 Communications Holdings is poised to absorb the punches and muscle into the rounds ahead.

Like most second-tier Pentagon contractors, L-3[LLL] is a stealth player in an industry dominated by high-profile companies that build aircraft, ships and weapons.

L-3 specializes in making, maintaining and upgrading electronic nerve systems of high-tech guidance, surveillance and communications systems.

"I don't have to build airplanes and tanks and ships," said L-3 Chief Executive Frank Lanza.

Good thing, because while those sectors are ripe for a slowdown, L-3's focus on military maintenance and upgrades puts it in one of the defense industry's few growth areas.

The Bush administration reportedly will seek to trim the Pentagon budget by $10 billion to $15 billion a year over five years. Major aircraft and ship development programs are expected to take much of the hit.

Meanwhile, spending on maintenance and upgrades is expected to grow 10% to 15% a year over the near term. This should help L-3 maintain double-digit financial gains well into the future.

The New York-based company expects to post $9.4 billion in revenue this year, up from less than $6.9 billion in 2004.

On Oct. 26 L-3 reported third-quarter sales of $2.5 billion, up 40% from the prior year. Earnings rose 25% to $1.11 a share, 2 cents above First Call estimates. Still, the company's stock fell nearly 6% over a two-day period following the earnings announcement.

First Call analysts expect full-year profit to rise 24% to $4.15 a share, then climb 18% to $4.89 in 2006.

L-3 has used acquisitions to drive much of its top-line growth, and that strategy shows no signs of slowing. In September, the company announced a $49 million purchase of Eotech, which makes holographic weapons.

In July, L-3 completed its biggest deal to date: a $2.65 billion buyout of San Francisco-based Titan Corp., which makes "black budget" products.

The deal catapulted L-3 to the forefront of companies providing secret electronic wares to intelligence agencies such as the CIA, Defense Intelligence Agency and National Security Agency.

Titan is expected to post sales of $2.4 billion this year behind double-digit growth. The acquired firm brought aboard 12,000 new employees — about 75% of whom have classified security clearance — and pushed L-3's total payroll to 59,000 employees.

The buyout also telegraphed a shift for L-3, watchers say.

"They've been executing on this (acquisition) strategy for a number of years, but their latest deal, Titan, brings them to a whole new level," said Peter Arment, vice president of industry tracker JSA Research.

Secure Niche

L-3 was founded in 1997. From the start, it has been geared to the mobile and high-tech military and intelligence needs of the post-Cold War world.

Like other military suppliers, L-3 has gotten a big boost from efforts to battle terrorism and strengthen homeland security.

For example, the company produces the bomb-detecting apparatus used in most airports, rail stations and ports, and is a leader in the simulated training market. It also sells a surveillance package used by the Coast Guard and law enforcement agencies.

A soldier uses the XM25 gun sight, which is produced by L-3 Brashear, a division of L-3 Communications.

Work to protect railways and subways — especially in Europe — should produce considerable gains, analysts say. Just about every European country has an elaborate rail and/or subway system.

"L-3 is well-positioned to become a significant market leader in providing technology for rail security," said Peter Arment, a vice president at industry tracker JSA Research. "That could prove a bigger global market than airport security, especially given the recent attacks in London."

L-3 does have a few challenges. One is competition, which comes from industry heavyweights Honeywell International[HON] in commercial aviation electronics, General Dynamics[GD] in classified high-tech gadgetry and Lockheed Martin[LMT] in training systems.

The concern is that a company like Lockheed, which posted more than $35 billion in 2004 sales, can invest what's necessary to capture the lion's share of markets.

Lanza downplays the threat. He says the Titan deal should pad L-3's cushion against predators and Pentagon budget swings. It also will be the last of its size for the foreseeable future, he says.

"The model of the last nine years was to get size," Lanza said. "We are large enough now that we are going to shift to smaller acquisitions and grow at a reasonable level."

After Titan, L-3's largest unit is Integrated Systems, which works on aircraft maintenance and upgrades and high-tech electronics. It has about 6,000 employees and accounted for 20% of L-3's revenue last year while growing at 10%.

L-3 will have four major business areas in 2006: aircraft modernization, projected to bring in $2.5 billion in revenue; classified intelligence systems, forecast at $3 billion; specialized products such as collision-avoidance systems for aircraft, $3.6 billion; and government services, $2.8 billion.

Meanwhile, the firm will continue to scout buyouts in niche areas, Lanza says, with prices ranging from $50 million to $400 million.

"You'll see more by the end by the year, and we'll spend $700 million to $1 billion a year on them for the next several years," he said.