

Kiplinger's

PERSONAL FINANCE

STOCKS | A boom in defense spending is good news for this **MILITARY ELECTRONICS MAKER**. *By Courtney McGrath*

THE SPYMASTER

BEFORE the ancient Hebrews could conquer Canaan, Moses dispatched a dozen spies to scout the Promised Land. Ten reported, incorrectly as it turned out, that the Canaanites were too formidable, and the Israelites ended up wandering in the wilderness for 40 years. Fortunately for our leaders, the art of military reconnaissance has become much more sophisticated. Today, unmanned U.S. planes fly over Iraq and other world hot spots 24 hours a day, taking pictures, picking up communications signals and tracking the movements of fighters and materiel.

If high-tech spying keeps the U.S. ahead of its foes, L-3 Communications deserves some of the credit. L-3 makes sensors, sonar devices, encrypted-communications systems and other tools for gathering vital information and feeding it back to the military. "We help determine where the enemy is, what he's doing and where targets are, so we can give fighters the information they need to destroy them," says CEO and co-founder Frank Lanza.

Opportunistic origins. Lanza and his partners launched L-3 in 1997, a sluggish period for the defense industry. With the Cold War over, military spending had been shrinking (in after-inflation dollars), and small contractors were folding left and right. But Lanza, now 71, thought that much of the technology that these failing companies had produced was worth saving. The plan, he says, was to "build one big company that would be like a high-tech Home Depot."

Since then, a voracious L-3 has swallowed 40 companies, with spectacular



SPOTLIGHT | L-3 Communications

- **Market value:** \$4.4 billion
- **Biggest customer:** Department of Defense (64% of sales)
- **Shareholder services:** 212-697-1111
- **Cash on balance sheet:** \$448 million
- **Debt-to-equity ratio:** 0.85

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success. Analysts expect sales to reach \$4.5 billion in 2003, according to Thomson First Call—four times greater than 1998 revenues. And things can only get better as Congress loosens the purse strings on defense spending. Meanwhile, analysts expect profits of \$2.25 per share this year and \$2.67 in 2003, up from just 63 cents in 1998. "L-3 is a tightfisted organization," says Bill D'Alonzo, chief investment officer of Friess Associates, which manages the Brandywine funds. "Its managers don't hesitate to cut costs."

In the aftermath of Tyco International's troubles, L-3's reputation as a serial

acquirer has hurt its share price. The stock sank from a May high of \$66 to \$45 in mid October. But, Lanza says, investors needn't worry about a Tyco-like implosion: "We've gone through every accusation and passed every test. Plus, we are under rigorous audit by the Department of Defense, which commercial companies aren't."

At its reduced price, the stock sells at 17 times analysts' 2003 consensus earnings estimate, a bit more than the overall market's price-earnings ratio. The premium is warranted, says analyst Stephen Murphy of CIBC World Markets. "This is a company that, without acquisitions, can generate annual earnings growth north of 15%," he says. "There aren't many sectors of the economy you can say that about now."

Strong position. New York City-based L-3 faces little competition. In general, the biggest potential threat comes from prime defense contractors that are L-3 customers, such as Lockheed Martin and Raytheon. But if any-

thing, says Murphy, the big weapons makers are contracting out *more* of their complex electronics manufacturing, not less, to the likes of L-3.

Investors' main concern—other than making sure that L-3 makes smart purchases and that its acquisitions mesh well—is the possibility of a sharp cut-back in military spending. Barring a breakout of peace around the globe, that just isn't in the cards. L-3, which also makes explosive-detection devices that U.S. airports must use for screening luggage, is the ideal company for a security-conscious world. **IK** —Reporter:

ALISON STEVENSON

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