General Dynamics Corporation

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Valuation Date: December 6th, 2018	**Recommendation:** BUY	**Stock Exchange:** NYSE
Current Price: $169.15	**Target Price:** $197.24	**Sector:** Industrials
Ticker: GD	**Industry:** Aerospace and Defense	**Headquarters:** Falls Church, Virginia

INTRODUCTION

General Dynamics Corporation (GD) was founded and incorporated in the state of Delaware in February 1952, and its business segments are combat systems, information systems and technology, marine systems, and aerospace. Each segment supports the United States government as well as other military allies around the world. Beginning in 1952, the company grew gradually through its acquisitions up until the 1990s when the company sold almost all of its enterprise except two main components: military-vehicles and submarines. Since then, General Dynamics has developed to specialize in military combat weapons, machines, and systems while also heavily specializing in information technology and cybersecurity aspects of military databases within the past decade.

RECOMMENDATION

We recommend a **BUY** for General Dynamics due to the current target price of $197.24 which represents a 16.61% upside to the current General Dynamics price of $169.15. This valuation is based on an even weight distribution of General Dynamic's discounted cash flow as well as an EV/EBITDA ratio. The even weight distribution for the valuation is a conservative estimate by the team and therefore the potential upside could be more than our expectation. We also conducted a monte carlo simulation and generated 10,000 outcomes of the stock price, after analysis the results showed there is a 70.48% probability of BUY for the General Dynamics stock. Moreover, we believe that the key drivers used in our investment thesis are not priced into the current stock price which results in an undervalued stock for General Dynamics.

INVESTMENT THESIS

General Dynamics is a great buy for many reasons including its positive outlook for its Information Systems and Technology (IS&T) segment fed by government defense spending, and its diversification of revenue streams and constant dividend. Even though the company has been seeing good organic growth, mergers and acquisitions play a role in boosting growth as well. Lastly, the progress of the Aerospace segment is poised for new growth moving forward. These reasons are demonstrated as follows:

Information Technology (IT) and Government Defense Spending

The company has shown tremendous growth and opportunity to grow with its IS&T segment. With the purchase of CSRA earlier this year, General Dynamics was able to boost Q2 revenue by 19.5% and Q3 revenue by 19.97%. The revenue in the segment was also up 116% from a year ago, and CSRA has not been fully implemented into the business yet. Without including revenues from CSRA, GDIT was still up 7.1%. The current market for IT is focusing more on scale of business as a differentiator and competitive factor, and by purchasing CSRA, General Dynamics has doubled its IT segment, better positioning itself in the market. Another great part about the acquisition is GDIT and CSRA have very similar business structures for their operations including their intelligence, health and civil, and defense lines of business. CSRA will be able to help General Dynamics centralize certain functions like business development and solution architecture, which currently get pushed down to its divisions like GDIT. CSRA was ahead of General Dynamics in this aspect, and this strategy and style will be implemented moving forward. One quick example of what CSRA can help GDIT do moving forward is the milCloud 2.0 contract with the Defense Information Systems Agency. This contract was to complete a cloud-based computing service for defense use, and they have been highly successful thus far, possibly bringing on classified information in 2019. Funds are typically increasing for defense and intelligence agencies, and the federal market in general is looking for larger scale projects. Also, information technology needs to be revamped to be more modern across the board on the federal level.

Diversification of Revenue Streams and Constant Dividend

Annual revenue for General Dynamics in 2017 was split across its four different business segments, Information Systems and Technology (IS&T), Aerospace, Marine Systems, and Combat Systems, by margins of 28%, 26.2%, 25.8%, and 19.2%, respectively. The company was not over reliant on one segment of its business to support the other segments. Looking to the most recent Q3 2018, the revenue split in the same order was 25.4%, 22.3%, 22%, 16.7%. The company also split mission systems from IS&T, and that segment resulted in 13.5% of revenue. By diversifying its revenue streams, General Dynamics is able to hedge itself from changes in defense demand and also from fluctuations in the business cycle. When the business cycle is in expansion, the aerospace segment does very well with its sales of private jets due to higher levels of business spending. When the market contracts, defense spending is usually not as volatile as business spending, and the defense revenue stays fairly constant. By receiving roughly 70% of its revenues from defense contracts, General Dynamics is well positioned to do well in most market conditions. For example, when aerospace revenue fell following the recession, it was offset by higher revenues from IS&T, Marine Systems, and Combat Systems in 2009 and by IS&T and Marine Systems in 2010. Also, being in a late stage expansion cycle of the economy, there is a possibility of economic downturn within the next one to three years. By receiving the dividend from this stock, the Student Managed Investment Fund would be receiving a cash flow to offset other losses in the portfolio.

Aerospace Progress

General Dynamics has developed two new private jets, the G500 and the G600. These aircraft are setting industry records for speed, and they will be able to offer customers shorter flight times to get to their destinations. The first G500s were delivered in Q3, and eight to 10 are expected to be delivered in Q4. The first G600s are expected to be delivered in 2019, and their margins are expected to be higher due to the movement down the learning curve from producing the G500s. General Dynamics also holds about 42 percent of the Chinese market for private jets, and the recent trade truce between the United States and China shows promise for the coming year.

Mergers and Acquisitions

General Dynamics was seeing slightly stagnant revenue growth until this year when it purchased CSRA to help with its IS&T segment. General Dynamics has seen revenue growth of nearly 20 percent in Q2 and Q3, and Q4 is also expected to see similar growth. The full implementation of CSRA is still being finalized, and General Dynamics is already seeing significant revenue growth. As a mature company, General Dynamics will likely see large spurts of growth with new innovations in its technologies or through mergers and acquisitions, and this could be a key area for the company moving forward.

VALUATION

For valuation, a discounted cash flow (DCF) and an enterprise value to earnings before interest, taxes, depreciation, and amortization multiple (EV/EBITDA) were used to determine a target price for General Dynamics. For the DCF model, assumed growth for 2018, 2019, and 2020 was 18%, 15%, and 12% as we believe revenues from business jets and Information Systems and Technology will help drive growth. A Q3 WACC of 8.5% and a terminal growth percentage of 3% were used as well. After calculating the model, a target price of $206.21 was reached, which offers a 22% upside on the current price of $169.15. For the EV/EBITDA valuation, a peer group average for EV/EBITDA of 12.51 was calculated using ratios from five close competitors. A 2018 EBITDA of $5377 was calculated and then multiplied by the average ratio to get an enterprise value of $66,810.61. After subtracting the cash and adding the net debt, that total was divided by the number of outstanding shares to get a target price of $188.28 per share, which represents a 11.31% upside to the current price of $169.15. Taking a 50/50 weighted average of both target prices, a weighted average target price for General Dynamics is $197.24, providing a 16.61% upside to the current price of $169.15

RISKS

Certain risks facing General Dynamics include: change in political administration, economic conditions, and competition. These risks are explained as follows:

Change in Political Administration

The Trump Administration has actively proposed spending increases to the military and a larger need for defense spending moving forward. Due to this, a defense budget of over 700 billion USD was passed for 2018, the largest defense spending budget ever. With the looming mid-term elections, a shift in political control of the House or the Senate to the Democratic party could result in decreased military spending in the near future. Also, with the next presidential elections occurring in 2020, a new president with different opinions on defense spending could also cause the defense budget to decrease, limiting the amount of potential revenue for General Dynamics.

Economic Conditions

General Dynamics' production and sale of business jets is very cyclical. Businesses are more prone to purchase business jets during times of economic expansion when they have excess cash to spend. During times of recession, demand for business jets tends to fall which poses a risk for the revenue of General Dynamics. Aerospace accounts for roughly 22% of revenue for the company, so a decrease in this would need to be offset by the other revenue segments to keep the business stable.

Competition

Competition is fierce in the defense industry. The main defense companies are constantly competing for contracts from the US government. Some of the competing companies are Northrop Grumman, Boeing, and Lockheed Martin, and they all have business structures that allow them to be very competitive with General Dynamics. Many times, if a company has shown its competency completing a certain type of contract, it is seen as a better choice for similar contracts in the future.

PAST YEAR'S STOCK PERFORMANCE

The following chart shows General Dynamics' stock price performance compared to the Standard and Poor's 500 index. General Dynamics is the black line.

As noted in the above chart, the S&P 500 outperformed General Dynamics since May 2018. The underperformance was caused by a couple factors including the merger with CSRA, the purchase of the nacelle line from Nordam, and a miss for Q3 revenue targets. General Dynamics' stock price went below its 52-week low late in October, and it is poised to rise back up, making this the perfect time to buy the stock. It has already shown that rising potential as the stock price increased from around 167 to 179 in the last few days of October. Since then the market has seen some volatility due to Chinese trade talks which has caused some decline in the stock price; however, moving past this period, General Dynamics will see its stock bounce back and approach the price target.

PEER ANALYSIS

Name	Mkt Cap (USD)	EPS - 1 Yr Gr:Y%	Sales Growth YoY	P/E	ROE	ROA	Dvd 12M Yld
General Dynamics Corp	52,833.12	15.17	12.33	16.46	26.80	7.96	2.03
Lockheed Martin Corp	85,162.74	6.66	9.26	16.67	338.89	10.91	2.67
Raytheon Company	51,460.06	8.48	6.59	20.46	22.97	8.43	1.88
Textron Inc	13,365.31	-6.50	1.66	19.07	13.16	4.90	0.15
Boeing Co/The	206,182.14	13.71	6.09	23.59		8.87	1.80

When compared with a group of its peers, General Dynamics has metrics that are very favorable. Sales growth year over year trailing twelve months is leading the group, along with the earnings per share year over year growth. The company also has one of the lowest prices to earnings ratios showing that it is not overvalued in comparison with the group. General Dynamics has the second highest return on equity and 12-month dividend yield as well. The lower return on assets is due in part to the acquisition of CSRA earlier in the year and the more recent acquisition of the nacelle line from Nordam Group after it filed for bankruptcy.

Phebe N. Novakovic
Chairman and CEO – Jan. 2013

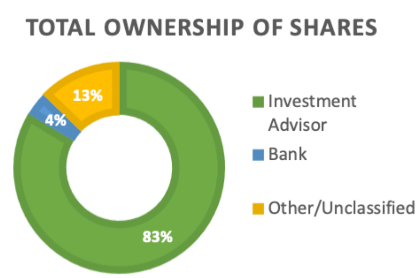
- 4 years' experience in the CIA and U.S. Dept. of Defense.
- 17 years with General Dynamics
- 48th most powerful women

MANAGEMENT

The current CEO and Chairman of General Dynamics is Phebe Novakovic whose tenure with the corporation began in 2001. Her compensation, as well as the corporation's officers, are in line with the competitor's executive compensation values. Moreover, in August of 2018, the Board of Directors (the "Board") elected a new Executive Vice President for Information Technology and Mission Systems ("EVP") to replace the current EVP S. Daniel Johnson who indicated his intent to retire at the end of this year. The Board chose Christopher Marzilli to succeed Mr. Johnson and who is currently the Vice President of the Corporation and President of the General Dynamics Mission Systems. This is a positive repositioning for the corporation to take, hiring from within its ranks and specifically from the same segment of the corporation. General Dynamics firmly believes in the continued growth and success of the corporation which is proven by the year-to-date repurchase of 2.1 million outstanding shares. This demonstrates that the management of the corporation similarly believes the stock is undervalued.

OWNERSHIP OF SHARES

Type of Holder	% Shares Held	% Position Change
Institutional Shareholders	83.62	+6.98
Insider Shareholders	3.65	+0.38
Other/Unclassified Shareholders	12.73	+/- 0.00



Holder Name	Curr. Position	Position Net Change	% Outstanding
Capital Group Companies Inc.	25,758,244 shares	+656,941 shares	8.70
Vanguard Group Inc.	20,905,951 shares	+357,032 shares	7.06
Newport Trust Co.	20,878,698 shares	(620,059) shares	7.05
BlackRock Institutional Trust Co.	17,451,297 shares	+426,955 shares	5.89
Wellington Management Group LLP	11,877,734 shares	+4,651,176 shares	4.01