

FY13 Sequestration Cuts Applied Unevenly With Some Surprises

- We crunched some of the data in the "Department of Defense Report on the Joint Committee Sequestration for Fiscal Year 2013" which showed detailed cuts by program.
- For Procurement, total Army resources (FY13 budget plus unobligated balances) were cut 4.4% by sequestration, Air Force was cut 7.0% and Navy and Defense-Wide were each cut by 7.7%
- The 8.1% percentage cut to RDT&E was greater than cuts to other categories and was more evenly distributed among the three major branches of the military.
- Unobligated balances in Procurement and RDT&E were cut more than fiscal year 2013 enacted levels.
- "Army Other" was spared cuts in Procurement as were Air Force space programs in "Other." This suggests that some companies whose products are funded by these categories may see less of an impact from FY13 sequestration than consensus anticipates.
- Total base and OCO Investment budget authority declines 12% in FY13 from FY12.

We reviewed a 438-page [report](#) the DoD released that detailed the impact of sequestration on FY13 accounts. The total cut required by sequestration was \$37.2 billion and was applied to base budget and OCO (Overseas Contingency Operations) enacted levels plus unobligated balances that had been appropriated in prior years. Because the President had exempted Military Personnel, those accounts were not reduced by sequestration. The \$37.2 billion reduction thus fell on O&M (Operations and Maintenance) accounts, Procurement, RDT&E, Military Construction and Family Housing. Sequester cut FY13 or prior year balances--the reductions are *not* from FY12 levels, though we discuss those comps in this report.

Exhibit 1 summarizes how sequestration was applied to major appropriations categories. Exhibit 1 also shows that percentage cuts to FY13 enacted levels were less than cuts to unobligated balances. This may not ultimately matter to defense contractors as they rely on both enacted funds and prior year's balances that become obligated through contracts or other legally binding mechanisms.

Affected companies:
ATK, BA/LN, BA, CACI, DCP,
EGL, GD, HII, LLL, LMT,
MANT, NOC, SAI, TXT, XLS

Exhibit 1. Research, Development, Test & Evaluation Took Deepest Percentage Cut in FY13 Sequester.

| Base and OCO | FY13 Enacted | Unobligated Balances | Total Resources | FY13 Cut | Prior Year Cut | Sequestration Cut | FY13 Cut as % of enacted | Prior Yr Cut % Unobligated | Cut as % of Total | Revised Resources |
|--------------------------------|--------------|----------------------|-----------------|----------|----------------|-------------------|--------------------------|----------------------------|-------------------|-------------------|
| Military Personnel | 149.7 | - | 149.7 | - | - | - | - | - | - | 149.7 |
| O&M (Operations & Maintenance) | 272.8 | 9.5 | 282.2 | (19.5) | (0.9) | (20.3) | -7.1% | -9.1% | -7.2% | 261.9 |
| Procurement | 109.8 | 36.7 | 146.5 | (5.7) | (4.1) | (9.8) | -5.2% | -11.2% | -6.7% | 136.7 |
| RDT&E (Research) | 69.6 | 5.0 | 74.6 | (5.4) | (0.6) | (6.1) | -7.8% | -12.7% | -8.1% | 68.5 |
| All other | 13.4 | 11.1 | 24.4 | (0.7) | (0.4) | (1.0) | -5.2% | -3.2% | -4.3% | 23.4 |
| Total | 615.1 | 62.3 | 677.4 | (31.3) | (6.0) | (37.2) | -5.1% | -9.6% | -5.5% | 640.2 |

Source: Capital Alpha Partners, Department of Defense. Note: \$\$ billions

There was more variability than we anticipated in how cuts were applied and clearly some program areas were protected while others took bigger hits. The distribution of cuts challenges some consensus views, as we explain below. However, we would not look at reductions in isolation of other potential budget actions, particularly for FY14. Nonetheless, the data in Exhibit 2 should be discussed by analysts and investors with managements to see how this impacts their plans and assumptions for 2013-15.

Exhibit 2 shows broad Procurement categories by each branch of the military and defense-wide accounts as well.

- No program in "Army Other" was cut by sequestration, and that was a surprise to us. This category includes a variety of communications, command & control, tactical surveillance, combat support and training equipment. It suggests that companies whose products are funded by this category may see less of any impact from FY13 sequestration. Some of these companies could include Comtech, Exelis, Finmeccanica (DRS), General Dynamics (portion of IS&T), Harris (radios) and L-3 Communications (electronic products).
- The other Procurement category that saw relatively little impact was "Air Force Missiles." That label is somewhat misleading, as this segment includes a number of unclassified space programs (e.g. Advanced EHF, GPS III, SBIRS High) and classified programs as well. Procurement was trimmed 0.3%. Segments of some of the primes that address military space may thus be less impacted (Boeing, Exelis, Lockheed Martin, Northrop Grumman). However, the larger "Air Force Other" took a 7.7% cut that impacted some other space programs, and that needs to be factored.
- Because "Army Other" was not cut by sequestration, the \$1.2 billion sequestration cut was 4.4% of the \$27.7 billion in total Army funding that was sequesterable. The other branches of the military saw larger absolute and percentage cuts. Total Navy Procurement resources were cut 7.7%, and Air Force Procurement was cut 7%. Defense-Wide, which includes activities such as the Missile Defense Agency, was cut 7.7%
- One of the analytic issues with sequestration is that it impacted unobligated balances from prior years and amounts enacted in FY13. Not surprisingly, some of the largest unobligated balances were in long production-cycle Procurement categories--namely Aircraft and Shipbuilding. The cuts to these balances--particularly to Shipbuilding

accounts--have been discussed in Congressional hearings and the issue has been partially addressed in mark-ups of the FY14 budget. For example, House Appropriations Defense Subcommittee added a net \$923 billion to Navy Shipbuilding, in part to cover prior year cuts to *Virginia* class submarines (General Dynamics, Huntington Ingalls are prime and program is important for Babcock & Wilcox).

Exhibit 2. Army Procurement Was Least Cut

| Procurement (\$\$ billions) | FY13 Enacted | Unobligated Balances | Total Resources | FY13 Cut | Prior Year Cut | Sequestration Cut | FY13 Cut as % of enacted | Prior Yr Cut % Unobligated | Cut as % of Total |
|-----------------------------------|--------------|----------------------|-----------------|--------------|----------------|-------------------|--------------------------|----------------------------|-------------------|
| Army | | | | | | | | | |
| Aircraft | 6.5 | 1.6 | 8.1 | (0.3) | (0.3) | (0.6) | -4.5% | -17.7% | -7.1% |
| Missiles | 1.6 | 0.3 | 1.9 | (0.1) | (0.0) | (0.1) | -7.0% | -8.4% | -7.2% |
| Wheeled & Track Combat Vehicles | 1.9 | 0.7 | 2.6 | (0.1) | (0.2) | (0.2) | -3.6% | -21.2% | -8.5% |
| Ammunition | 2.0 | 0.3 | 2.3 | (0.1) | (0.1) | (0.1) | -3.1% | -19.8% | -5.4% |
| Other | 7.0 | 3.9 | 10.9 | - | - | - | - | - | - |
| JIEDDO (counter IED) | 1.6 | 0.3 | 1.9 | (0.1) | (0.0) | (0.2) | -8.5% | -6.5% | -8.2% |
| Total Army | 20.5 | 7.1 | 27.7 | (0.7) | (0.5) | (1.2) | -3.3% | -7.6% | -4.4% |
| Navy | | | | | | | | | |
| Aircraft | 17.5 | 3.9 | 21.5 | (0.8) | (0.8) | (1.6) | -4.6% | -20.9% | -7.6% |
| Weapons | 3.0 | 0.8 | 3.8 | (0.2) | (0.1) | (0.3) | -7.4% | -10.2% | -8.0% |
| Ammunition | 0.9 | 0.1 | 1.0 | (0.1) | (0.0) | (0.1) | -6.5% | -15.8% | -7.6% |
| Shipbuilding & Conv. | 15.1 | 8.0 | 23.1 | (0.7) | (1.0) | (1.8) | -4.8% | -12.9% | -7.6% |
| Other Navy | 6.0 | 1.4 | 7.4 | (0.4) | (0.1) | (0.6) | -7.1% | -10.6% | -7.8% |
| Marine Corps | 2.1 | 1.2 | 3.3 | (0.1) | (0.2) | (0.3) | -5.2% | -13.5% | -8.3% |
| Total Navy | 44.7 | 15.5 | 60.1 | (2.3) | (2.3) | (4.6) | -5.2% | -14.7% | -7.7% |
| Air Force | | | | | | | | | |
| Aircraft | 11.6 | 10.3 | 21.9 | (0.9) | (0.9) | (1.8) | -7.5% | -8.8% | -8.1% |
| Missiles | 4.9 | 1.0 | 6.0 | (0.0) | (0.0) | (0.0) | -0.2% | -1.1% | -0.3% |
| Ammunition | 0.7 | 0.1 | 0.8 | (0.0) | (0.0) | (0.1) | -5.9% | -12.3% | -6.8% |
| Other | 19.7 | 1.3 | 21.0 | (1.4) | (0.3) | (1.6) | -6.9% | -18.8% | -7.7% |
| Total Air Force | 36.9 | 12.8 | 49.7 | (2.3) | (1.2) | (3.5) | -6.2% | -9.3% | -7.0% |
| Defense-Wide | 5.1 | 0.8 | 5.9 | (0.4) | (0.1) | (0.5) | -6.9% | -12.6% | -7.7% |
| National Guard & Reserve | 1.5 | 0.3 | 1.8 | (0.0) | (0.0) | (0.0) | -0.3% | -3.3% | -0.9% |
| Chemical Agents & Munitions Dest. | 1.3 | 0.0 | 1.3 | - | - | - | 0.0% | 0.0% | 0.0% |
| Defense Production Act | 0.2 | 0.2 | 0.4 | (0.0) | (0.0) | (0.0) | -11.2% | 0.0% | -5.8% |
| MRAP Vehicle Fund | (0.4) | | (0.4) | | | | | | 0.0% |
| Total Procurement | 109.8 | 36.7 | 146.5 | (5.7) | (4.1) | (9.8) | -5.2% | -11.2% | -6.7% |

Source: Capital Alpha Partners, Department of Defense. Note: \$\$ billions

Exhibit 3 shows that cuts to RDT&E were more evenly distributed by branch of the military.

Exhibit 3. RDT&E Cuts More Evenly Distributed

| RDT&E | FY13 Enacted | Unobligated Balances | Total Resources | FY13 Cut | Prior Year Cut | Sequestration Total Cut | FY13 Cut as % of enacted | Prior Yr Cut % Unobligated | Cut as % of Total |
|-------------------------------|--------------|----------------------|-----------------|--------------|----------------|-------------------------|--------------------------|----------------------------|-------------------|
| Army | 8.7 | 0.9 | 9.5 | (0.7) | (0.1) | (0.7) | -7.6% | -10.9% | -7.9% |
| Navy | 16.7 | 1.2 | 17.9 | (1.3) | (0.2) | (1.5) | -7.6% | -16.5% | -8.2% |
| Air Force | 25.3 | 1.7 | 27.0 | (2.0) | (0.2) | (2.2) | -7.9% | -13.7% | -8.2% |
| Defense-Wide | 18.7 | 1.3 | 20.0 | (1.5) | (0.1) | (1.6) | -8.0% | -9.0% | -8.0% |
| Operational Test & Evaluation | 0.2 | 0.0 | 0.2 | (0.0) | (0.0) | (0.0) | -5.8% | -28.6% | -6.5% |
| Total | 69.6 | 5.0 | 74.6 | (5.4) | (0.6) | (6.1) | -7.8% | -12.7% | -8.1% |

Source: Capital Alpha Partners, Department of Defense. Note: \$\$ billions

Exhibit 4 compared base and OCO Procurement and RDT&E budget authority enacted for FY12 to FY13 enacted less the sequester cut for FY13. It does not factor in unobligated balances. Our aim here was to show the year-over-year decline in Budget Authority. Outlay declines should be less--maybe in the mid-single digit range. However, absent Congressional action

for FY14-15 to shore-up cuts to unobligated balance our gut is to add 100-200 bps to those outlay rates of the decline.

Exhibit 4. With Sequester, Total FY13 Investment Falls 12% From FY12 Level

| | FY12 enacted | FY13 enacted post sequestration | Yr/yr % change |
|-----------------------------------|--------------|------------------------------------|----------------|
| Procurement | | | |
| Army | | | |
| Aircraft | 6.5 | 6.2 | -3% |
| Missiles | 1.5 | 1.5 | 0% |
| Wheeled & Track Combat Vehicles | 2.0 | 1.8 | -12% |
| Ammunition | 1.9 | 1.9 | -2% |
| Other | 9.1 | 7.0 | -23% |
| JIEDDO (counter IED) | 2.4 | 1.4 | -41% |
| Total Army | 23.4 | 19.9 | -15% |
| Navy | | | |
| Aircraft | 17.9 | 16.7 | -7% |
| Weapons | 3.2 | 2.8 | -14% |
| Ammunition | 0.9 | 0.8 | -9% |
| Shipbuilding & Conv. | 15.0 | 14.4 | -4% |
| Other Navy | 6.2 | 5.6 | -9% |
| Marine Corps | 2.8 | 2.0 | -28% |
| Total Navy | 46.0 | 42.3 | -8% |
| Air Force | | | |
| Aircraft | 13.7 | 10.7 | -22% |
| Missiles | 5.8 | 4.9 | -15% |
| Ammunition | 0.6 | 0.7 | 10% |
| Other | 20.4 | 18.3 | -10% |
| Total Air Force | 40.5 | 34.6 | -15% |
| Defense-Wide | 5.1 | 4.7 | -7% |
| National Guard & Reserve | 1.0 | 1.5 | 50% |
| Chemical Agents & Munitions Dest. | 1.5 | 1.3 | -10% |
| Defense Production Act | 0.2 | 0.2 | 13% |
| MRAP Vehicle Fund | 0.6 | (0.4) | -162% |
| Total Procurement | 118.3 | 104.1 | -12% |
| RDT&E | | | |
| Army | 8.3 | 8.0 | -4% |
| Navy | 17.7 | 15.5 | -12% |
| Air Force | 26.4 | 23.3 | -12% |
| Defense-Wide | 19.5 | 17.2 | -11% |
| Operational Test & Evaluation | 0.2 | 0.2 | 12% |
| Total | 72.0 | 64.2 | -11% |
| Memo: Investment | 190.4 | 168.3 | -12% |

Source: Capital Alpha Partners, Department of Defense. Note: \$\$ billions.

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