

May 28, 2012

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Sequestration Scenarios From Defense Perspective

- There are different views at Capital Alpha on what happens between now and late 2012 regarding probabilities of deals to defer sequestration or the probability that there is no deal at all.
- Our personal view rests in part on the outcome of the November election and this factor is why we are reluctant to make a high conviction call just now.
- Our most likely scenario is a deal in late Nov. through mid. Dec. 2012 to defer implementation of sequestration until March-May 2013 when a broader deal can then be crafted that eliminates sequestration.
- This is a consensus view - that sequestration won't happen - but the risk for defense investors is that it is either resolved or, not likely, occurs at a time when broader market liquidity is trailing off.
- CNAS will brief its report "Sustainable Preeminence..." on May 29. NOC and LMT are presenting at Bernstein's conference on May 31. BAH reports on May 30 and SAI and ESL report on May 31.

Exhibit 1 at the end of this note shows a rough timeline and our personal assessment of probabilities associated with sequestration. There are variant views at Capital Alpha on the probabilities surrounding sequestration: these views on probabilities of different scenarios involving sequestration are our own.

Defense is the stock market sector that could be most impacted by sequestration since about half of the budget cuts mandated by the Budget Control Act would fall on the DoD budget. (We discussed the math of these cuts in a [research note published on May 20](#).) In addition, non-DoD discretionary cuts would also affect non-DoD programs at defense and other firms, including work done for NASA and other federal agencies.

Sequestration risk continues to be in the news and this past week was no exception. [A CBO report](#) discussed the impact on U.S. GDP of the "fiscal cliff," which includes sequestration as the law now stands. Sen. John Thune (R-SD) and Sen. Jeff Sessions (R-AL) introduced a bill on May 23 requiring the Administration to submit a report by July 9, 2012 detailing sequestration cuts and their impact. The SASC FY13 National Defense Authorization Act included a provision that requires "SecDef to submit a detailed report...on the impact on the DoD of the sequestration..." And there was sparring in the press. Sen. Reid (D-NV) stated in an interview in *Politico* that: "I am not going to back off the sequestration. That's

the law we passed. We did it because it wouldn't make things easy for us. It made it so we would have to do something. And if we didn't, these cuts would kick in. To now see the Republicans scrambling to do away with the cuts to defense, I will not accept that."

Our personal views are as follows:

- Barring some sort of national security event (e.g. a war with Iran or on the Korean peninsula), we see virtually no chance of a deal prior to the November election that would remove the threat of sequestration. We don't expect Republicans to back off a core commitment not to raise taxes and, equally, we don't see any willingness by Democrats to accept that sorts of cuts to non-defense spending embodied in the House FY13 Budget Resolution - certainly not without the Republicans giving ground on their opposition to tax increases. Compromise prior to election might stoke concerns that the "winner" would gain advantage going into Nov. 6.
- The election will matter to what happens in the lame duck session of Congress that could run from mid-November into late December (and possibly into the first days of January). There are clearly other scenarios to consider for Nov. 6 than the two most likely ones shown in Exhibit 1. As described in "Election Risk Reports," [the latest Capital Alpha view](#) is a 55% probability that the election results in a status quo, albeit with Republican gains in the Senate, but not enough for a majority; President Obama re-elected, and the House remains firmly in Republican control. The other most likely outcome is that Gov. Romney is elected, the Republicans retain a majority in the House, and gain more than 50 seats in the Senate (but less than 60). There are far lesser probabilities that we can consider in our analysis if Chuck Gabriel's and Loren's Smith's assessment changes in coming months.

We've assigned our personal assessment of probabilities in Exhibit 1 to various outcomes in a lame session and subsequent outcomes in the spring of 2013 with the figures in blue those that might occur if the status quo prevails and those in red to paths that could be taken if Republicans gain the White House and the Senate as well as retain a majority in the House.

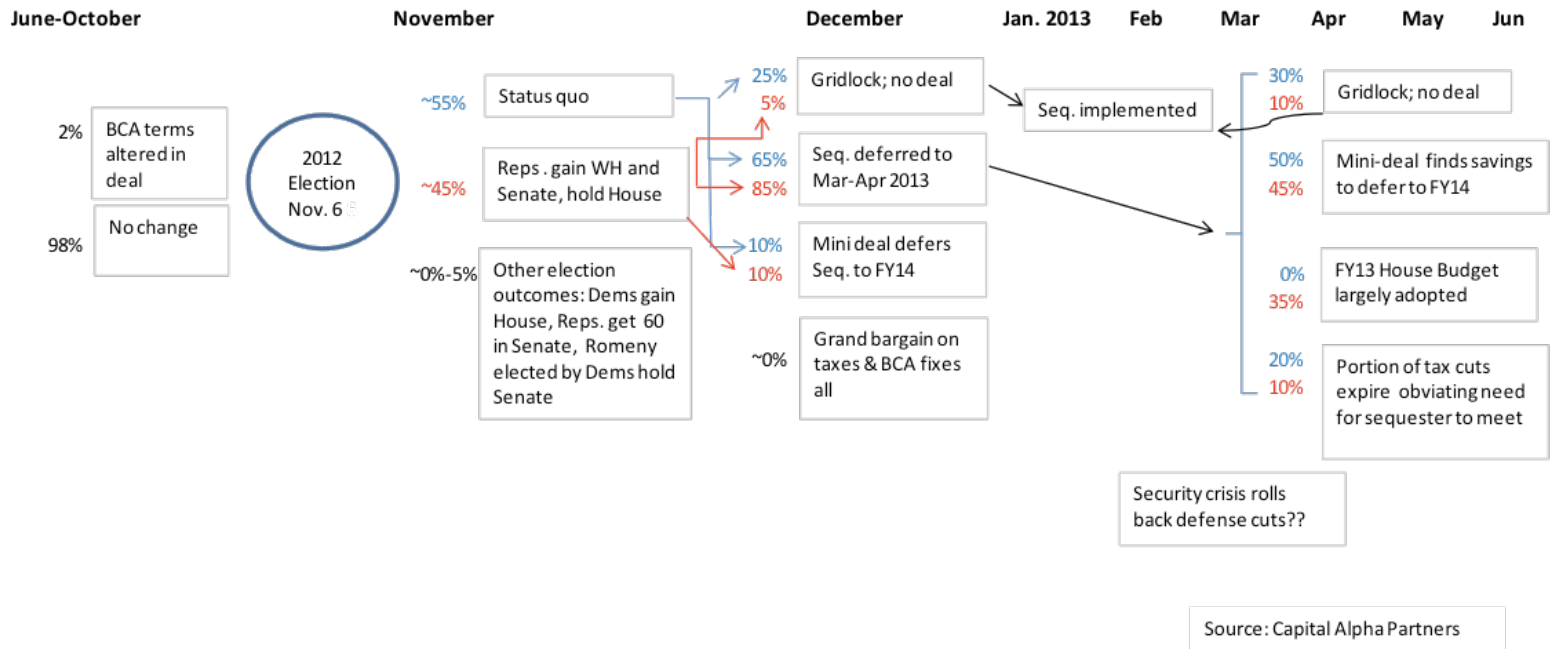
- Lame duck sessions of Congress in Presidential election year historically have not been all that productive and this is one reason we are personally skeptical that anything more than a short-term deferral of sequestration (with 3-5 months of budget savings to keep the rating agencies content) is likely. In the lame duck session of 2008 (110th Congress 2nd Session) when President Obama was elected, Democrats were the majority in the House. The Senate was virtually split with 49 Republicans and Democrats each and 2 independents, although they caucused with the Democrats. During the Nov. 19, 2008-Jan. 2/3, 2009 session, the only substantive legislation was House passage on Dec. 10, 2008 of H.R. 7321, which provided aid for the automobile industry. The Senate did not vote on this legislation. The lame duck session in 1980 after Ronald Reagan defeated President Carter was an exception when a number of bills were passed, including a budget, but in that period, (96th Congress, 2nd Session) Democrats were the majority in both the House and Senate.

Our personal view is the magnitude of the issues that a 2012 lame duck session of Congress will need to deal with--that collectively make up the "fiscal cliff"-- entails that a grand sweeping deal that resolves all these issues is almost impossible. And even a deal to find \$110 billion in cuts to defer sequestration for a year is unlikely if the status quo is confirmed on Nov. 6. The central players behind the failed Super Committee effort in the fall of 2011 will still be in place and will have an eye on the 2014 mid-term elections. If further political polarization evidenced in primary elections so far is confirmed in House and Senate races, this suggests to us that a lame duck session is less likely to cut a deal that a more polarized 113th Congress could gag on, particularly if Republican leadership gives ground in a lame duck session deal on its core issue of revenues, without addressing tax reform in a more comprehensive manner.

- The most probable scenario in our personal view is that Congress agrees to defer implementation of sequestration until the March-May 2013 time period. This outcome is more likely, in our view, if Gov. Romney is elected President. The Republican majority in the House will undoubtedly want to give a new Republican President a chance to step into and solve problems and not jump off a cliff. Sequestration is chaotic and inefficient and there was bipartisan support for the amendment in the SASC National Defense Authorization Act for the DoD to report on its potential effects. Sequestration's impact does not exclude states of Senate Democrats and it impacts non-defense discretionary programs that are important for Democrats. As we note below, Senate Democrats (assuming Republican don't gain 60 seats) will still be in a position to influence the mother of all federal spending/revenue-/debt ceiling battle that is going to rage in early 2013. The threat of defense cuts under sequestration is still a lever they are likely to want handy to influence the outcome of those debates.
- We realize there is another scenario where sequestration is triggered on Jan. 2, 2013 but then Congress reverses it in the months that follow. Sequestration may be more valuable as a deterrent and once used its deterrent value is gone. If triggered, defense programs will be cut, workers laid off, and contracts broken. It is very messy and inefficient and we'd like to see the explaining that takes place when costs are detailed for not only its implementation but its reversal.
- There remains risk that either no agreement is reached in a lame duck session and sequestration occurs and there is another scenario where sequestration is deferred for several months but is ultimately triggered. We assign a 25% probability if the November election confirms the current status quo in DC and only a 5% probability if the Republicans take the Senate and White House.
- We've focused on the March-May time period for when a deal that defers sequestration will then have to see the issue resolved. Our thinking is that 1) by then, another debt ceiling debate will be in full swing, 2) implementing discretionary budget cuts any later than six months into the fiscal year (after multiple CRs) will be difficult enough and 3) it gives a new session of Congress and possibly a new Administration time to sort issues out.
- Positive surprises for the defense sector could be 1) contrary to our expectations, there is a deal before Election Day and 2) Republicans win the White House in November as

well as a majority in the Senate. Republican gains might boost the possibility that the House version of the FY13 budget is ultimately adopted in the spring of 2013, but this also may depend on the degree of insurgency that Democrats in the Senate wage in the 113th Session. They could make things as difficult for Senate Republicans in 2013 as Republicans have made for Democrats in 2011-12.

Exhibit 1. Sequester Decision Tree and Timeline From Defense Perspective



Analyst Certification

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