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OA - Q2 2017 Orbital ATK Inc Earnings Call

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OVERVIEW:

Co. reported 2Q17 consolidated revenues of $1.115b, adjusted operating income of $139m and adjusted diluted EPS of $1.56. Expects 2017 consolidated revenue growth to be 3.5-4.5% and adjusted EPS to be $5.95-6.25.

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CORPORATE PARTICIPANTS

Barron Beneski

Blake E. Larson *Orbital ATK, Inc. - COO*

David W. Thompson *Orbital ATK, Inc. - Co-Founder, President, CEO & Director*

Garrett E. Pierce *Orbital ATK, Inc. - CFO*

CONFERENCE CALL PARTICIPANTS

Howard Alan Rubel *Jefferies LLC, Research Division - MD and Senior Equity Research Analyst of Aerospace and Defense Electronics*

Jose Caiado De Sousa *Crédit Suisse AG, Research Division - Research Analyst*

Joseph William DeNardi *Stifel, Nicolaus & Company, Incorporated, Research Division - VP*

Louis Harold Raffetto *Deutsche Bank AG, Research Division - Associate Analyst*

Matthew Akers *UBS Investment Bank, Research Division - Associate Director and Associate Analyst*

Michael Frank Ciarmoli *SunTrust Robinson Humphrey, Inc., Research Division - Research Analyst*

Samuel Joel Pearlstein *Wells Fargo Securities, LLC, Research Division - MD, Co-Head of Equity Research & Senior Analyst*

William Daniel Ledley *Cowen and Company, LLC, Research Division - Associate*

PRESENTATION

Operator

Good day. My name is Elsa, and I will be your conference operator today. At this time, I would like to welcome everyone to the second quarter 2017 financial results conference call. (Operator Instructions) Mr. Barron Beneski, Vice President of Investor Relations, you may begin your conference.

Barron Beneski

Okay. Thank you, Elsa, and thank all of you who have joined us this morning as we provide financial results for the second quarter of 2017. Please note that this morning's press release, the live audio feed for this call and backup presentation slides are all available on the Investors section of our website, which is at orbitalatk.com. An archive of the slide and a replay of the call will be available later today. Joining me on today's call are Dave Thompson, Orbital ATK's President and Chief Executive Officer; Garrett Pierce, the company's Chief Financial Officer; and Blake Larson, our Chief Operating Officer. We will begin the call with opening remarks from Dave, Garrett and Blake, and then we will be ready to take your questions.

Before we get under way, please note the safe harbor paragraph that is included on Chart 3 of our investor presentation and at the end of today's press release. This paragraph emphasizes the major uncertainties and risks in the forward-looking statements we will make this morning. Please keep these factors in mind as we discuss future strategic initiatives, operational outlooks and financial guidance during today's call. And with that, I'll turn it over to Dave Thompson.

David W. Thompson - *Orbital ATK, Inc. - Co-Founder, President, CEO & Director*

Thanks, Barry, and good morning, everyone. Orbital ATK achieved substantial revenue growth, strong profit margins, solid operational progress and continued good new business results in the second quarter of the year. Major highlights from the quarter are summarized on Chart 4.

Starting with our financial results, the company reported quarterly revenue of $1,115,000,000. This was about 3% higher than in the same period last year and reflected especially strong top line growth in 2 of our 3 business segments. Our overall adjusted operating margin was a strong 12.5%.

This was about 200 basis points lower than the margin in the second quarter of 2016, but this was entirely due to the absence of substantial cumulative contract profit adjustments from later quarters that added to last year's margin, as Garrett will explain shortly.

Adjusted EPS was above plan at $1.56 on stronger margins and a somewhat lower tax rate. Free cash flow was negative $52 million, primarily as the result of a temporary production slowdown in our small-caliber ammunition operation, and also with some differences in timing of milestone payments, but with no adverse impact on our full year cash outlook. Finally, as Garrett will also discuss, we are increasing our revenue outlook and raising our EPS guidance for 2017 to reflect solid first half performance and continued strong new business wins.

Turning to operational performance. Each of Orbital ATK's business segments achieved good progress on a wide range of R&D and production programs in the second quarter. Some examples included producing and launching 4 missile-defense interceptor and target vehicles, delivering record levels of aerospace composite structures, manufacturing high volumes of tactical missiles, warheads and other armament products, completing our seventh Space Station cargo mission and deploying the second group of 10 next-generation Iridium Communications satellites.

In addition, our Small Caliber Division management team and workforce really did a remarkable job of recovering from and resuming ammunition production after a mid-April accident at the Lake City, Missouri facility temporarily interrupted our operations there. Blake will cover these and other operational accomplishments a little later in the call.

Finally, the company's new business bookings in the second quarter were strong, totaling over $1.6 billion. This boosted first half new orders and options to nearly $3.7 billion and resulted in a firm backlog of about $9.5 billion and a total backlog of about $15.4 billion, the latter figure marking a new record high for the company.

While the second quarter's firm book-to-bill ratio was 83%, firm book-to-bill for the first 6 months of the year was a still robust 117%.

Now I'd like to turn the call over to Garrett, who will discuss our financial results in greater detail and cover some other related matters. He'll then pass the phone to Blake to review recent operational activities, and then I'll return to provide some additional comments on new business. And after that, we'll open things up for your questions. Garrett?

Garrett E. Pierce - *Orbital ATK, Inc. - CFO*

Thank you, Dave, and good morning. Today, we reported preliminary unaudited GAAP results and adjusted non-GAAP measures in our earnings release press release. The non-GAAP financial results that we are discussing today are intended to provide our investors and our analysts with a helpful understanding of the financial performance and the earning power of Orbital ATK. Reconciliations of our preliminary adjusted financial results to comparable GAAP financial measures are included in the appendix in our earnings release and today's presentation slides. Let me begin with a reminder from our first quarter earnings call about EPS distribution in the second quarter of 2016, which benefited from approximately $0.36 or $28 million of cumulative catch-up adjustments that would normally have been recognized in the third and fourth quarter but were reported in the second quarter because the books were still open, as we worked our way through last year's restatement. Specifically, $0.26 or $19 million of the $0.36 would have been recognized in the third quarter, and the balance, $0.10 or $9 million in the fourth quarter. I have more comments later on how we see the year unfolding from a financial perspective.

So now let's take a look at the company's consolidated operating results for the second quarter 2017. As shown on Page 5 of the presentation charts, second quarter 2017 consolidated revenues were $1,115,000,000, up $31 million or about 3% as compared to the second quarter of last year. The growth resulted from revenue increases in Flight and Space Systems segments, partially offset by lower Defense Systems segment revenues and higher corporate eliminations. Adjusted operating income was $139 million in the second quarter, down 12% compared to the same period last year. This decline was largely due to the movement of favorable cumulative profit adjustments into Q2 2016 that pertain to Q3 and Q4 of 2016, as I detailed in my opening remarks.

Comparatively, contract profit adjustments in the second quarter of 2016 were approximately $56 million or 37% of EBIT versus $33 million or 24% of EBIT in the second quarter of 2017. Our adjusted earnings per share for the second quarter 2017 was $1.56 per diluted share as compared to $1.67 reported in the comparable quarter of -- in 2016, which, again, benefited by the $0.36 from the profit, adjustments moving into the quarter that I already described. I'd also note that the tax rate for the second quarter 2017 was lower than we were forecasting for the full year of 2017, due primarily to increased benefits from the research and development tax credit.

Turning to segment results. Page 5 also summarizes the second quarter 2017 revenues, adjusted operating income and operating margin in our Flight, Defense and Space Systems segments. It also shows the corporate level eliminations of intersegment revenues and related operating income adjustments.

Segment GAAP results are also covered on pages 4 to 6 in our press release.

Here, I will note that the Flight Systems and Space Systems segments revenues increased 14% and 8%, respectively, as strong new orders booked in 2016 and in early 2017 are now driving top line revenue growth. The primary drivers were commercial and military aircraft structure programs in Flight Systems, government satellite programs in Space Systems. The Defense Systems group revenues decreased about 7%, as expected, largely due to lower activity on small-caliber ammunition contracts because of the temporary Lake City factory interruption that occurred during the quarter. The margin decline at the operating group level is primarily due to unfavorable comparisons with the elevated level of cumulative catch-up adjustments in the second quarter of 2016 that we discussed this morning.

I will note that on a sequential quarter-over-quarter basis in 2017, margins were up by 170 basis points to 12.5% in the second quarter versus 10.8% in the first quarter, with improvements in all 3 business segments.

Now turning to cash and cash -- capital deployment. Our second quarter 2017 cash flow from operations was negative $4 million. Capital expenditures were $52 million. And adjustments for merger and other nonrecurring costs were $4 million, resulting in adjusted free cash flow of negative $52 million in the second quarter.

Free cash flow in the second quarter, and indeed for the first half of the year, was impacted by the fact that our schedule of major operational milestone and other contract provisions that trigger cash payments are heavily weighted to the second half of the year, as was the case in 2016. In addition, the first satellite servicing system called Mission Extension Vehicle, MEV, is consuming elevated capital spending to support its production, testing and deployment schedule. At the end of the second quarter 2017, our cash balance was $74 million, as shown on Chart 6.

Turning to capital deployment activities. We returned $35 million to our shareholders in the form of cash dividends and share repurchases in the second quarter and about $53 million for the first half of 2017. We are also executing on a multiyear repurchase program that has authorized up to $450 million for a 3-year period from April 2015 through March 2018. We resumed purchases late in the second quarter as the restatement work was completed, repurchasing about $16 million of common stock in the last month of the quarter. Since the inception of the program, we have repurchased about $220 million of common stock as of the end of July 2017.

With this in mind, Chart 6 shows our capital deployment and investment plans for the year. At this time, we anticipate returning up to $225 million to shareholders in repurchases and dividends, or roughly 80% of targeted free cash flow for the year. We also plan to invest approximately $360 million in R&D and capital equipment, including about $135 million in support of the 3 prominent growth initiatives that we've previously highlighted and now are under way.

Finally, we expect to reduce debt by $40 million and to make a $25 million cash contribution to the company's pension program this year.

We are updating our annual financial guidance, which is summarized on Chart 7, with increases to our full year revenue, earnings outlook and reaffirming our operating margin and free cash flow expectations. We've increased revenue guidance by $50 million on the low end and $25 million on the high end, which equates to consolidated revenue growth in the $150 million to $200 million range or 3.5% to 4.5%, with our Flight and Defense Systems segment accounting for most of the growth and the Space Systems segment being about flat year-over-year. Overall, the margins are projected to be similar to last year's, with stronger corporate contributions from the FAS/CAS income adjustment offset somewhat by lower segment margins, particularly in the Flight Systems, which is experiencing a change in contract mix, fewer cume catch adjustments and higher research and development spending.

We are now forecasting adjusted EPS to be in the range of $5.95 to $6.25, with a GAAP tax rate of about 28% and an average share count around 57.5 million shares. Free cash flow is targeted to be in the range of $250 million to $300 million.

Other guidance items include interest expense of approximately $65 million, $100 million in FAS/CAS net pension income, which is recognized at the corporate line. As we previewed in the first quarter call, we see the second half of the year being stronger than the first in terms of revenue, earnings and cash flow as we ramp up on several new programs in the coming months and begin to execute some of the shorter-cycle work that we recently booked and resumed full production at Lake City's small-caliber ammunition plant to make up for the production decline that we experienced in the second quarter.

As previously guided, this year's free cash flow will be recognized in the second half, particularly in the fourth quarter, simply based on the timing of milestone achievements and related cash flows collections, very similar to what we've experienced in 2016. Thank you, and now I'll turn it over to Blake.

Blake E. Larson - *Orbital ATK, Inc. - COO*

Okay. Thanks, Garrett, and thanks for all of you who call in. Operationally, Orbital ATK had a very strong quarter across all 3 operating groups, with program execution and operational results leading to the achievement of a number of key milestones in the second quarter of 2017.

As shown on Chart 8, these included the following important events. In the Flight Systems group, we successfully supported the test of the U.S. Ground-based Midcourse Defense system with flights to boat and Orbital ATK boost vehicle interceptor rocket and an intercontinental ballistic missile target vehicle. The company-produced propulsion systems also supported 2 Minuteman test flights and the launch of the European Space Agency's Maxus rocket. In the second quarter, the company achieved a new record for production of composite aircraft parts, including the 150,000th part for the Airbus A350 program. The company also successfully tested the launch abort motor for the Orion spacecraft, completed casting of the final booster segment for NASA's first Space Launch System vehicle and completed integration and test of the Antares rocket for the upcoming OA cargo logistics mission to the International Space Station.

In the Defense Systems Group, we've produced approximately 220 million rounds of small-, medium-, and large-caliber ammunition, as well as about 4,400 tactical missile motors, more than 3,200 precision artillery kits and 8,000 warheads and fuses in the second quarter. The company also marked the delivery of its 500th advanced anti-radiation-guided missile to the U.S. Navy, successfully test-fired the attitude control motor of the Orion spacecraft's launch abort system and demonstrated an unmanned aerial systems capability with a high success ratio.

In the Space Systems Group, we conducted the OA-7 cargo delivery mission to the International Space Station for NASA, along with the associated science experiments and microsatellite deployments from the Cygnus spacecraft. The next Cygnus vehicle, the OA-8 spacecraft, is complete and ready to launch.

Other second quarter highlights feature the successful launch of the second group of 10 Iridium NEXT satellites that the company assembled, integrated and tested and handed over to a government -- a customer, 2 international -- or 2 national security satellites following the completion of in-orbit testing. The company also delivered over 430 spacecraft components and launched several suborbital research rocket and scientific balloon missions for NASA.

Overall, Orbital ATK played major roles in 2 recent highly successful interceptor tests for the Missile Defense Agency. The first mission, conducted on May 31, involved an ICBM target designed and built by Orbital ATK to demonstrate the capabilities of the ground-based interceptor, also manufactured by the company, to destroy a long-range target. The second and most recent mission in early July included a successful intercept involving our air-launched IRBM target against the FAS system. And these and other ways, we are proud to support the United States' missile defense shield in protecting and defending the country.

Recent operational execution has been outstanding through the company, not only as highlighted by the missile defense tests, but also by a completion of another cargo logistics mission to the Space Station, the testing of an astronaut safety system for NASA and the continuation of our small-caliber ammunition team's tremendous work to resume production following an unfortunate industrial accident that temporarily curtailed production activity.

As forecasted, we are now in a position to scale up production activity in the second half of the year to meet annual demand volumes for both government and commercial customers by year-end.

Now switching to new product innovation. With over $135 million internal R&D investment this year, along with several times that amount in customer funding, our teams have also been executing very well on more than 20 product development programs and innovative new technology research activities, including the 3 major growth initiatives we shared with you last year, as well as a number of new technologies in areas ranging from advanced propulsion to counter-UAS systems.

In these and other areas, we continue to maintain a strong balance of entrepreneurial agility and innovation, combined with the industrial discipline and scale to efficiently deliver differentiating capabilities to meet customer needs. It include close partnering with suppliers, teammates and customers in a collaborative fashion. To provide you with a sense of the diversity and scale of our operations, Chart 9 is a brief summary of the company's major operational accomplishments since the merger was completed 2.5 years ago. As this shows, our Flight Systems Group conducted as prime contractor or supported as propulsion and structures supplier 81 space missile launches in the last 30 months. Our Space Systems team built 28 satellites and carried out over 60s suborbital research flights during that time. Our Defense Systems unit delivered more than 350 advanced tactical missiles, produced nearly 200,000 other missile subsystems and manufactured more than 100 million rounds of ammunition a month.

Finally, our merchant supplier businesses delivered about 500 aircraft and over 100 satellite shipsets of structures, components and subsystems to various customers. We are very proud of what the team has accomplished during this time and are excited about the future. As always, we remain committed to operational excellence and continuous improvement for our customers who count on us for their improved important missions. Across all of our businesses, we continuously strive to further improve key operational metrics such as safety, product quality, on-time delivery, supply chain efficiency and working capital efficiency. Dave, with that, I'll turn it back to you for our new business report and final comments.

David W. Thompson - *Orbital ATK, Inc. - Co-Founder, President, CEO & Director*

Thanks, Blake. I'll now provide some details about second quarter new business volume and our outlook for the remainder of 2017. As shown on Chart 10, Orbital ATK's Defense Systems group was our strongest contributor to new business in the second quarter, with about $950 million in orders and option exercises or about 59% of the company's total second quarter volume. Major new defense business awards included contracts for tactical missile warheads and munition fuses, as well as orders for small-caliber ammunition from both commercial and military customers. In the first 6 months of the year, defense booked a 6-month record of $2,200,000,000 in new business or about 60% of the company's $3,675,000,000 in total first-half orders and options. In fact, Defense won nearly the same total volume of new business in the first half of 2017 as it received in all of 2016.

Flight Systems received $545 million in new contract awards and option exercises in the second quarter or about 33% of the company's total volume. Major contributors to Flight's new business wins included contracts for space and strategic rocket propulsion systems and for military aircraft structures. For the first half of the year, Flight booked $1,120,000,000 in new business or about 30% of the company's total.

Finally, on Space Systems, new business wins added $125 million or 8% to the company's second quarter totals. Several contract awards or add-ons to existing programs in military satellites, spacecraft components and space technical services were the substantial factors in Space's quarterly orders.

For the first 6 months of 2017, Space received $355 million worth of contract awards, representing about 10% of our total new business volume in the first half of the year.

I would also note that about 55% of company-wide new bookings in the first half of 2017 were for short-cycle contracts, that is, those requiring 2 years or less to complete from order received to final delivery. Another 30% of our first half new business bookings were for medium-cycle orders, those with a duration ranging from 2 to 4 years. This continued the substantial shift that we saw early in the year away from the preponderance of longer-cycle orders in 2015 and through a good bit of 2016.

As also displayed on Chart 10, firm backlog at the end of the first -- at the end of the second quarter was $9,515,000,000, about 10% higher than it was this time a year ago. Total backlog, which includes options and undefinitized orders, was $15,370,000,000, up 4% over last year and a new record high for the company. This backlog now provides approximately 98% of our targeted revenue for 2017, about 75% of expected revenue for next year and around 50% of planned revenue in 2019.

Looking ahead to the third and fourth quarters, Orbital ATK currently has about $3 billion in outstanding proposals for customer decisions that are expected by the end of the year or in the early part of 2018. And with favorable congressional action anticipated on the fiscal year 2018 U.S. government budget, the company's prospects are good for continued robust new business volume throughout next year as well.

In summary, as shown on Chart 11, Orbital ATK's second quarter was characterized by strong financial performance, with revenue, operating margins and EPS at or above plans for the period. Together with continued good new business bookings, our first half financial results point to increased revenue and earnings for the full year, as indicated by our updated guidance for 2017. The company extended our record for solid operational performance as well with another quarter of 100% mission success, with increasing production rates on various aircraft and armament programs and with good progress on a wide range of new product R&D investments. And finally, we maintained a balanced approach to capital deployment with share repurchases, dividends and internal growth investments in the quarter.

With that recap, we're now ready to respond to your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And your first question comes from the line of Sam Pearlstein from Wells Fargo.

Samuel Joel Pearlstein - *Wells Fargo Securities, LLC, Research Division - MD, Co-Head of Equity Research & Senior Analyst*

You had talked a little bit about this, but just there has been quite a bit of activity in the whole missile defense test area. Can you just talk about the targets business now in terms of how big it is maybe? Or have you seen any change in the pace of business now that there's been an increasing use? It would seem like we need to replenish some of those.

David W. Thompson - *Orbital ATK, Inc. - Co-Founder, President, CEO & Director*

Yes. Sam, our missile defense business, which is pretty broadly based, covering medium-, intermediate- and long-range targets, as well as interceptors for long-range defense and subsystems to other prime contractors for interceptors for shorter-range purposes is one of the bright spots in our portfolio. Targets, in particular, have grown very nicely over the last several years, and we expect to see continued growth in both target revenue and in flight rates over the coming years. The Missile Defense Agency is updating its longer-term plans now. And I think the final results of that will be favorable from the standpoint not only of enhancing the protection of our country, but also looking at it from Orbital ATK's business standpoint. So we're pretty bullish about the current situation as well as the future outlook for targets and other missile defense products provided by the company.

Samuel Joel Pearlstein - *Wells Fargo Securities, LLC, Research Division - MD, Co-Head of Equity Research & Senior Analyst*

Great. And then, Garrett, can you talk a little bit -- just we see revenues and earnings both going up across the company, no change in the cash flow. Is that a timing issue? Is there anything else that is a negative in terms of the cash? How should we think about what it would take to get the cash flow to move a little bit?

Garrett E. Pierce - *Orbital ATK, Inc. - CFO*

Sam, there's nothing negative. It's simply timing, quite frankly. And we're very comfortable with the range of $250 million to $300 million, as reported out on the call. And it has to do with milestones and collection thereof, as we saw last year. So it doesn't translate from the revenue growth into the cash flows. That cash flow is really milestone-based, and we're very comfortable with it.

David W. Thompson - *Orbital ATK, Inc. - Co-Founder, President, CEO & Director*

I would also add to that, Sam, that beginning last year, continuing this year and next year, our capital deployment investments are elevated. And our company-funded R&D investment level also is above what might be considered a normalized level in support of, as Blake indicated, a couple of dozen major new product development or enhancement programs. We feel like those investments are going to be very good and very important for the company's future, even though they do take a little bit out of short-term cash flow in this year and last year and next year.

Blake E. Larson - *Orbital ATK, Inc. - COO*

And then, Blake, uniquely, for this year, in this quarter, remember, as talked about last quarter, the cash impact on second quarter from the Lake City temporary interruption was consistent to what we said, But obviously is further pushing the recovery into the back half of the year.

Samuel Joel Pearlstein - *Wells Fargo Securities, LLC, Research Division - MD, Co-Head of Equity Research & Senior Analyst*

And that Lake City, did that affect your -- did that cause any unfavorable adjustments on that program from where you were running before?

Blake E. Larson - *Orbital ATK, Inc. - COO*

No, they do not.

David W. Thompson - *Orbital ATK, Inc. - Co-Founder, President, CEO & Director*

However, as Blake -- Sam, as Blake indicated, there was adverse revenue and cash impact in the second quarter, both in the range of $40 million to $45 million. We expect those to be recovered in the second half of the year, but those did impact the second quarter results.

Garrett E. Pierce - *Orbital ATK, Inc. - CFO*

But the estimates at completion, et cetera, estimate to complete it.

Blake E. Larson - *Orbital ATK, Inc. - COO*

So there was some impact to Q3, and it recovers fully by year-end.

Operator

And your next question comes from the line of Howard Rubel from Jefferies.

Howard Alan Rubel - *Jefferies LLC, Research Division - MD and Senior Equity Research Analyst of Aerospace and Defense Electronics*

A couple of things. One, can you update us, David, on the Antares program, and when you might expect the launch? And how many more launches this year?

David W. Thompson - *Orbital ATK, Inc. - Co-Founder, President, CEO & Director*

Yes, sure. Howard, as Blake alluded to, the Antares rocket as well as the Cygnus spacecraft, that it will launch on the next cargo mission to the Space Station, are now essentially built and tested and ready for cargo-loading at the Wallops Island launch site. We were and are on schedule to carry those out this month, but I think NASA's going to delay that probably until October in order to provide a full load of cargo. There's one particular item, a spare part or subsystem for the Space Station that they'd like us to carry on this mission. And that cargo element is going to pace the launch. It's running a bit later than previously expected. As a result, I think it now is unlikely that we will carry out 2 more cargo launches this year. I think we'll do one in the early fourth quarter and another one in the early first quarter of next year instead of the original plan, which had called for one this quarter and one in the final quarter of the year. But the hardware's in good shape and ready to go, and production and integration and test of both the Antares rocket and the Cygnus spacecraft for the upcoming mission have proceeded very smoothly. So we're looking forward to that launch as soon as all the cargo is ready to go.

Howard Alan Rubel - *Jefferies LLC, Research Division - MD and Senior Equity Research Analyst of Aerospace and Defense Electronics*

I appreciate that. That's helpful. And then -- so that would also have somewhat of an impact on cash because there's -- because you won't be able to receive -- well, the receivables won't be relieved a bit. So that you must be doing something else within the range that's reasonable because that's a fair chunk of the variability in the cash guidance.

David W. Thompson - *Orbital ATK, Inc. - Co-Founder, President, CEO & Director*

That's right. We expect to be able to offset any cash deferral on what would have been that third cargo mission in the fourth quarter with other opportunities throughout the company. So we're still very confident that cash flow for the full year will be in the original range, although the components that will add up to that cash flow will be a little different, CRS -- the CRS program being a little less. Other things are doing a bit better than expected.

Howard Alan Rubel - *Jefferies LLC, Research Division - MD and Senior Equity Research Analyst of Aerospace and Defense Electronics*

That's very helpful. And then finally, could you sort of update us a bit, David, on all these development programs and where you've been able to capture customer interest or where you have either ramps to higher or ramps where it was a nice effort and it's going to go away?

David W. Thompson - *Orbital ATK, Inc. - Co-Founder, President, CEO & Director*

Yes. I'd be happy to, Howard. We've focused a lot of our attention on 3 major new growth initiatives that we announced early last year. But keep in mind that those are -- while perhaps a bit outsized, those are only part of the 20-plus product development and technology research initiatives that are under way across the company. Those 3 major initiatives, one in each group, are all, at this point, going quite well and I just take them in turn. In our Flight Systems segment, the company and the Air Force are now in the second year of what may well be a 5-year jointly funded program to create a new intermediate and large class launch vehicle. As I've mentioned before, our objective, our joint objective, is to develop a family of vehicles capable of launching both defense as well as commercial and scientific satellites that are larger, heavier than those that can be accommodated by our current Antares rocket, and to have those new launchers ready for initial flights in 2020 or 2021. Our investments last year and this year, together with those of the Air Force, have covered the preliminary phases of design and facility expansion. We're expecting a joint go, no-go between the Air Force and Orbital ATK late this year or early next year concerning the next phase to actually move into full-scale development and testing of these vehicles in advance of commencing production and launch operations around the end of the decade. In Defense, early last year, we initiated a multiyear R&D program to develop a family of advanced medium-caliber ammunition that would build on and extend our recent innovations in a variety of technical areas, including precision, artillery, electronic fusing and advanced ordinates. Early this year, we demonstrated the first product in that family of 30-millimeter airburst round that works in conjunction with our medium-caliber gun systems, and that has been met with strong customer interest and several early orders. In just the past few months, we've conducted successful tests of the proprietary technology for miniature proximity fuses and some of the elements of active guidance that will be built into medium-caliber ammo rounds for the second and third products in that line over the next 18 months. So things are going quite well there, and we expect to demonstrate the second of the 3 products in the final months of this year or very early in 2018. And finally, in Space Systems, early last year, we initiated our commercial satellite servicing program with Intelsat, entering into a 5-year contract as our anchor customer. Late last year, we completed the initial design for the first vehicle. We recently finalized the design and are now well into construction of that first mission extension vehicle that Garrett referred to. If things proceed as planned, it will be the first of an eventual fleet of up to 5 of these geosynchronous orbit servicing vehicles, this first one being launched late next year and commencing operations about 18 months from now, in the early part of 2019. So altogether, the company invested about $75 million in R&D and CapEx in support of these initiatives last year. We expect somewhat higher levels of investment this year and next year. And all 3 at this point are making great progress and have very good prospects to accelerate the company's mid- and long-term growth beginning next year with Defense and then being supplemented in 2019 and beyond with Flight and Space Systems initiatives.

Operator

And your next question comes from the line of Michael Ciarmoli from SunTrust Robinson Humphrey.

Michael Frank Ciarmoli - *SunTrust Robinson Humphrey, Inc., Research Division - Research Analyst*

Garrett, just maybe housekeeping first. I think I heard the buyback, $16 million, may be spent so far since you've been able to resume that. And I guess, that leaves $134 million left for the year. Does the share count actually have potential to dip lower than that $57.5 million you guys have out there in the guidance? Or does that contemplate the buyback?

Garrett E. Pierce - *Orbital ATK, Inc. - CFO*

It compensates the buyback. And we -- the buyback that we've done thus far has been on our 10b-5 which is the structure. We have the ability to step into the market and have the capability and buy, under the rules, more than the structure. So what I'm saying to you is we're forecasting for the year of $150 million. We have ability to get there, and we'll see how things go.

David W. Thompson - *Orbital ATK, Inc. - Co-Founder, President, CEO & Director*

Just for clarification, Michael. The $16 million in repurchases that Garrett mentioned occurred just in the month of June. There have been additional repurchases since that time. But the $16 million figure just represents 1 month worth of repurchases.

Garrett E. Pierce - *Orbital ATK, Inc. - CFO*

And that was timed with the filing or statements -- the restatement.

Michael Frank Ciarmoli - *SunTrust Robinson Humphrey, Inc., Research Division - Research Analyst*

Right. And then just I know in the past that's come up. Free cash flow especially, I know you don't want to give guidance for '18, but there was maybe some caution there that free cash flow would be down. How do we look at that now with maybe the impact, as you guys were just discussing, with the launch slippage here? Does that actually improve the cash outlook potentially for '18?

David W. Thompson - *Orbital ATK, Inc. - Co-Founder, President, CEO & Director*

It could in a minor way, Michael. Let me just maybe provide a little broader perspective. The -- our 3-year target that we set back at the time the merger closed in early 2015, which we are on track to meet or slightly beat, provides for, over that first 3 years that we're now coming to the point of completion, a free cash flow or net income conversion pretty close to 100%, a little less, but 95% to 100%. And I think it's reasonable over the next 3 years that we'll see something in that same range. Over the past 3 years, free cash flow to revenue is likely to end up being just under 7%. I think we'll do a little better than that over the next 3 years, but we'll provide a more specific insight into our outlook for 2018 when we talk in the fall.

Michael Frank Ciarmoli - *SunTrust Robinson Humphrey, Inc., Research Division - Research Analyst*

Got it. That's helpful. And then just last one for me. The consumer ammunition agreement you guys announced with a couple of suppliers, does that change the sort of the slope of the growth outlook in the Defense segment or even the margin outlook as you guys start to execute on that next year?

Blake E. Larson - *Orbital ATK, Inc. - COO*

Certainly. One, we have culminated the multiparty agreements, as we put the press release out about a couple of weeks ago. And two, yes, that does. Once we get past February of 2018, the economic performance improves significantly on the commercial side. And so that would lead to better margins on the commercial side of the ammunition. And we see the market being fairly stable through that time period right now. So I think the answer is broadly yes to your question.

Operator

And your next question comes from the line of David Strauss from UBS.

Matthew Akers - *UBS Investment Bank, Research Division - Associate Director and Associate Analyst*

This is Matt on for David. I was wondering if you could give us an update, as you've done in the past, just the commercial satellite market in terms of how many awards have you seen this year? How many in your addressable markets and how many you think you can maybe win this year?

David W. Thompson - *Orbital ATK, Inc. - Co-Founder, President, CEO & Director*

Sure, I'd be happy to. Well, the story is not great there. So far this year, commercial operators have contracted for only 3 geosynchronous communication satellites. That's the market's weakest first half or yearly start in over a decade. In contrast, through this time last year, operators had purchased 7 satellites in the first half of 2016, and for the year, went on to buy 14 in total. And that was not a particularly great year. So the outlook right now, our outlook for this year is likely to be even weaker than last year, maybe 10 orders with 2 perhaps in our addressable segment. Now for Orbital ATK, fortunately, the weakness in the commercial satellite sector has been largely offset by strength in government demand. For example, in 2015, about 60% of our satellite sales were to government programs. That increased to about 75% last year, and we see a similar or maybe even a little greater fraction expected this year and next year. So we're doing well in -- very well in our government satellite business. And that's making up for what has been and what I think will likely continue for some time to be a pretty weak demand on the commercial side.

Matthew Akers - *UBS Investment Bank, Research Division - Associate Director and Associate Analyst*

Okay. And the, I guess, just one other one on CRS. As you guys sort of transition from CRS-1 to CRS-2, how do you think about that just at a high level impacting revenue margin and cash flow? And then what's kind of the timing of the impact?

David W. Thompson - *Orbital ATK, Inc. - Co-Founder, President, CEO & Director*

Well, from a revenue standpoint, there, I think, we'll be fairly steady, although the contribution from CRS-2 will increase and from CRS-1 will decrease. The crossover point where revenue from the new contract exceeds revenue from the old contract will be around the end of this year. From a profit standpoint, like we did at the -- in the early days of the CRS-1 contract, we are booking profit on the new contract at a more modest rate. Hopefully, our performance will lead to profit improvements over the coming years. But in the short term, while profits on CRS-1 are strong, and we expect them to continue to be through the completion of that contract's substantial completion late next year, CRS-2 margins will be more modest at least through 2018. But hopefully, we'll see some pickups beyond that time.

Operator

And your next question comes from the line of Robert Spingarn from Crédit Suisse.

Jose Caiado De Sousa - *Crédit Suisse AG, Research Division - Research Analyst*

This is Joe on for Rob. Garrett, there's an implied drop-off in Flight Systems margins from the 14% or so that you did this quarter. I'm wondering what drives that. I would have thought with an Antares launch, it would have been a little bit stronger. Or is it the case that Q3 is weaker, and then Q4 is stronger because of the launch? And then on the Defense side, it looks like the absence of Lake City helped your Defense margins this quarter, which is not that surprising. But as that starts to come back online, should that drive second half margins back down closer to Q1 levels, which would put you closer to the low end of the margin range for the year? Or do you think you can hold the 10% that you did in Q2, which would put you closer to the high end of the range for the full year?

Garrett E. Pierce - *Orbital ATK, Inc. - CFO*

Well, in the Flight, as I said in my script, there's a mix change there. And also, we're assuming lower cume catch adjustments in there. I think the Flight Systems growth is robust across the product lines that they have. And so the profit that we recognized last year had some significant cume catch-ups, which we won't see this year. But as we look across the propulsion side and the aerospace side, et cetera, they're all strong. And so I don't see any major deterioration other than what we forecasted today.

Blake E. Larson - *Orbital ATK, Inc. - COO*

And on the Defense side that you asked about, there will be some moderation in margin as the Lake City volume comes in harder in the third and fourth quarter.

Jose Caiado De Sousa - *Crédit Suisse AG, Research Division - Research Analyst*

Okay. And then your current backlog, as it stands today, what does the profitability of that backlog look like relative to the margins that you're delivering today? Is there pricing pressure in that backlog that you need to offset with cost-cutting just to hold your current margins? Or is that work already looking more profitable, such that margins can continue to rise year-after-year as long as you execute?

David W. Thompson - *Orbital ATK, Inc. - Co-Founder, President, CEO & Director*

I would say that in the aggregate sense that the operating margins in backlog are comparable to or incrementally stronger than the operating margins currently being generated. There has been pricing pressure in a couple of product lines, but I think that's been offset or somewhat more than offset by a combination of stronger results in other areas and reduced overhead cost compared to the time some of those contracts were bid and won. So in the aggregate, the embedded margins are comparable or somewhat better in backlog than the current performance.

Jose Caiado De Sousa - *Crédit Suisse AG, Research Division - Research Analyst*

That's very helpful, Dave. And a just final one for you, Blake. You mentioned the counter-UAS capability that you demonstrated this quarter. That sounded pretty interesting to me. Can you just give us some more details on that? Is that company-funded? And -- or is there a particular program of record that you're going after with that?

Blake E. Larson - *Orbital ATK, Inc. - COO*

It's primarily an external demonstration supported by the customers in the context of setting up the demonstrations, so they could get access to multiple technologies to compare. And we did that in 2 different kinds of forums. One was more of a handheld weapon deriving technology from an existing weapon we have, and another one was a combined kinetic and non-kinetic demonstration to handle both kinds of capabilities when you want to destroy or when you want to just defer or drop a UAV. And in either case, both of those demos were very successful. So we look forward to anticipate it, although we see a fair amount of demand forming, although not yet what really was structured on the customer side to fund that kind of capability. But we do see that as an opportunity for the future. And that area is one of the other 20-plus innovation and new product initiatives beyond the core 3 that Dave talked about.

Operator

And your next question comes from the line of Gautam Khanna from Cowen and Company.

William Daniel Ledley - *Cowen and Company, LLC, Research Division - Associate*

This is Bill Ledley on for Gautam this morning. Just wanted to follow up on the free cash flow. Any more color you can give on H2 and what you're expecting those milestone payments to be for Q3 and Q4? And any color programmatically would be helpful.

Garrett E. Pierce - *Orbital ATK, Inc. - CFO*

Well, in terms of the second half, we expect the third quarter to be positive. I think fourth quarter is really where the cash flow will come through at least in a number of our programs. Certainly, CRS is part of that and other major programs that we have. In terms of is there any risk in that, I think as long as we execute our backlog, as we've been talking about, we should be in that range comfortably, the $250 million to $300 million.

David W. Thompson - *Orbital ATK, Inc. - Co-Founder, President, CEO & Director*

As Garrett indicated, Bill, the comparison to 2016 quarterly cash flow is probably instructed here as well. We had -- if I remember correctly, we had -- the first and third quarters of last year were negative, the second and fourth were positive, and the fourth was strongly positive. I think what we'll see this year will be the same thing. With regard to the fourth quarter and the third quarter, as Garrett indicated, should be positive, but not quite as strong as the fourth quarter.

William Daniel Ledley - *Cowen and Company, LLC, Research Division - Associate*

Okay. And then just on the positive contract adjustments. You guys are overrunning your guide here in the first half. Can you talk about opportunities in Q3 and Q4, and if there's any conservatism baked around that 12% to 15% of EBIT for positive contributions?

David W. Thompson - *Orbital ATK, Inc. - Co-Founder, President, CEO & Director*

At this point, I wouldn't suggest that there's a lot of upside on that. We -- you're right. Year-to-date, we're running a bit higher than the 12% to 15%. I think, if I did the math right, we're about 17% of year-to-date EBIT relating to net cumulative cash adjustments. But certainly, the second quarter was a bit higher than that at about 24%. I would anticipate at this time the fourth quarter maybe a little stronger than the third. But I would not suggest, at this stage, that we'll move out -- we'll move substantially out of that midteen range.

William Daniel Ledley - *Cowen and Company, LLC, Research Division - Associate*

Okay. And then you guys are obviously executing very well on the composite of structures. Can you just update us as to where you are with Airbus and when we should start seeing that accounts receivable unwind? Is that a potential positive contributor to late 2018 free cash flow? Or any color there would be helpful.

Blake E. Larson - *Orbital ATK, Inc. - COO*

So we are at a point where we've delivered about 220 shipsets to Airbus for the A350. We are period cash-positive. We've crossed over. It's very small. So as the gap between costs continuing to go down and the price widens, obviously, that unwind speeds up. But it's also a function of the rate of delivery. So long-winded answer to your question, there's a little bit in '18, but it really gets to be more accelerated when you get to later '19, and then especially '20 and '21.

David W. Thompson - *Orbital ATK, Inc. - Co-Founder, President, CEO & Director*

I was just going to say, our team's done a very good job this year -- well, more than this year. Last year, we increased our monthly production rate by about 30%; ended 2016 producing just about 8 aircraft ship-sets per month. Since then, we've boosted the rate to almost 9, and we're on track to achieve about 10 -- about a 10 per month production and delivery rate by the end of this year and more to come after that.

William Daniel Ledley - *Cowen and Company, LLC, Research Division - Associate*

Okay. And then just a couple of clean-ups. Did you receive any CRS-2 orders in the quarter? And to your knowledge, did your competitors on that program receive any orders? And then I just want to clarify, are you still contemplating 2 commercial satellite orders for calendar '17? Or is that withdrawn?

David W. Thompson - *Orbital ATK, Inc. - Co-Founder, President, CEO & Director*

With regard to the CRS part of the question, no. We did not receive any CRS-2 orders in the second quarter. I don't know about what others may have received. I haven't heard of any being made.

Blake E. Larson - *Orbital ATK, Inc. - COO*

Not aware of any.

David W. Thompson - *Orbital ATK, Inc. - Co-Founder, President, CEO & Director*

And then on the commercial satellite side, I think 2 is probably -- 2 orders is probably optimistic for this year. One would be more -- I think we'd have more confidence in.

William Daniel Ledley - *Cowen and Company, LLC, Research Division - Associate*

Okay. And anything notable that you can offset that whole with? Because you kept space sales, obviously.

David W. Thompson - *Orbital ATK, Inc. - Co-Founder, President, CEO & Director*

Yes. I think continued strength in government satellite activity, particularly military, or defense-related satellite activity should offset or maybe go beyond offsetting any additional weakness on the commercial side.

Operator

And your next question comes from the line of Myles Walton from Deutsche Bank.

Louis Harold Raffetto - *Deutsche Bank AG, Research Division - Associate Analyst*

This is Lou Raffetto on for Myles. So I just want to go back to, I think it was, Blake's comments. You said you were spending a little bit more capital on the, it sounds like extension vehicle. So you maintained the spend for the years. So is that just timing? Or is there some -- you're shifting some of your spending on the investments?

Blake E. Larson - *Orbital ATK, Inc. - COO*

Yes. I think that might -- I think it might've been Garrett's comment. But this development of the Mission Extension Vehicle is progressing as scheduled. And that results in a corporate-level elimination.

Garrett E. Pierce - *Orbital ATK, Inc. - CFO*

Yes. It's on plan, on schedule and is expected. I just wanted to highlight the moving parts of it. So that's the answer.

Louis Harold Raffetto - *Deutsche Bank AG, Research Division - Associate Analyst*

All right. Sounds good. And then you spoke to free cash flow conversion of 95% to 100% is where you think you can be over the next 3 years, depending -- I mean, if we think about 2018 and the go, no-go decision later either this year or next year, I guess, I would assume that would provide some tailwind if it is a no-go?

David W. Thompson - *Orbital ATK, Inc. - Co-Founder, President, CEO & Director*

It could, although the way the new launch vehicle program is currently structured, it should not -- if it's a go, we don't anticipate it having -- putting a lot of pressure on 2018. R&D will be up some, but I don't think for just next year that it will make a big difference one way or the other. In future years, it could, but not in 2018.

Operator

And your next question comes from the line of Joe DeNardi from Stifel.

Joseph William DeNardi - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP*

It's Joe DeNardi on for Joe DeNardi. Dave, can you talk a little bit about the military space side of the business? I know that's been pretty strong for you of late. It seems like there's a lot of interest within the DoD to improve their capabilities there. I'm just wondering if that interest has kind of translated into orders for you yet or if that's still to come. I mean, when you look at the FY '18 budget request, is that side of interest reflected in it? Or is there upside?

David W. Thompson - *Orbital ATK, Inc. - Co-Founder, President, CEO & Director*

Well, it's a very -- it's a good question, and it is pointed to a very important and rapidly growing part of our business. I can't -- because a lot of the work we do there is restricted, I can't really comment in a lot of detail on some of the things we're working on. I can say, though, that over the past 4 quarters, 5 quarters maybe, going back to second or third quarter of last year, that, that has been an outsized contributor to new orders in our Space Systems sector. And at present, those orders are -- they're still coming in at a good clip, and they're translating to strong revenue growth in that product line. We expect, just as I mentioned earlier, that U.S. government satellite business, which includes not only the defense side, but the scientific side, to be probably 3x as large as the commercial satellite business in revenue terms this year and that ratio could potentially shift even more firmly towards government work next year or in the year after depending on the pace of recovery in the commercial market. So that's where we're deploying the lion's share of our people and our industrial resources now and where several of the unadvertised research and development investments that we're making are focused. So things are going very well there. It's definitely one of the brightest spots in our whole portfolio for this year and through the end of the decade.

Joseph William DeNardi - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP*

Okay. Yes, that's very helpful, Dave. And then, Garrett, when we think about, I guess, margins into next year, it would seem like there's going to be some pressure -- maybe some meaningful pressure from CRS-2. If the large class launch ramps up, there's probably some pressure from that. Maybe MEV is dilutive to some degree. It sounds like Defense maybe gets better from the commercial ammo contract, but can you just talk about some of the moving pieces as we -- just the set expectation for margins next year, what maybe some of the positive offsets could be?

Garrett E. Pierce - *Orbital ATK, Inc. - CFO*

Well, you're actually right on the commercial ammo. That's commercially set. We have to execute on that. If we execute on that, that will help immensely. And we are still working very hard on the vision 2022 contract to improve profitability there. So that would bolster that very well. I think as we look forward into next year, some of these adjustments we're getting -- a good part of these adjustments are improvements in operations lowering costs. And we plan to do that across the company. We have the ability to run our overhead through a number of plants where we may be doing government work, which helps the overall rates. So we are very, very focused on improving efficiency and cost reduction across the board. And I could get into some specific programs, but some of the programs I can't get into for competitive reasons, but that would be my response.

Joseph William DeNardi - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP*

Okay. And then, Dave, maybe just one on commercial satellites. I mean, given how weak orders there are and how fragmented that market is, are there opportunities maybe to partner or for a JV or other strategic alternatives to maybe try and lessen the impact of the cyclicality on your business?

David W. Thompson - *Orbital ATK, Inc. - Co-Founder, President, CEO & Director*

I think that's a good observation. And we have, in the past, considered that approach. And there's some discussions under way now along those same lines to see whether there might be partnership approaches that could -- that might make sense. I don't have anything that's far enough along to go much farther than that at this time, other than to say that we think along similar lines to what you've indicated and are exploring some possibilities that may come to fruition over the next couple of quarters.

Barron Beneski

Okay. And with that, and in the interest of time, I think we'll bring the call to a close. Thank you for joining us today. We look forward to speaking with you again when we report our third quarter 2017 financial results. This concludes today's call.

Operator

And this concludes today's conference. Thank you for your participation. You may now disconnect.
