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PRESENTATION

Operator

Good day ladies and gentlemen, and welcome to the third-quarter 2016 Huntington Ingalls Industries earnings conference call.

(Operator Instructions)

As a reminder, this conference call is being recorded.

I would now like to turn the conference over to your host for today, Dwayne Blake, Vice President of Investor Relations. You may begin.

Dwayne Blake - *Huntington Ingalls Industries Inc. - VP of IR*

Thanks, Sonia. Good morning and welcome to the Huntington Ingalls Industries third-quarter 2016 earnings conference call. With us today are Mike Petters, President and Chief Executive Officer, and Chris Kastner, Executive Vice President of Business Management and Chief Financial Officer.

As a reminder, statements made in today's call that are not historical fact are considered forward-looking statements and are made pursuant to the Safe Harbor provisions of federal securities law. Actual results may differ. Please refer to our SEC filings for a description of some of the factors that may cause actual results to vary materially from anticipated results.

Also in their remarks today Mike and Chris will refer to certain non-GAAP measures including certain segment and adjusted financial measures. Reconciliations of these metrics to the comparable GAAP measures are included in the appendix of our earnings presentation that is posted on our website.

We plan to address the posted presentation slides during the call to supplement our comments. Please access our website at huntingtoningalls.com and click on the Investor Relations link to view the presentation, as well as our earnings release.

With that I'll turn the call over to our President and CEO Mike Petters. Mike?

Mike Petters - *Huntington Ingalls Industries Inc. - President and CEO*

Thanks, Dwayne. Good morning, everyone. Thanks for joining us on today's call.

We released third-quarter 2016 financial results this morning that reflect solid overall operating performance driven by program execution at Ingalls. So let me share some highlights starting on page 3 of the presentation.

Sales of \$1.7 billion were down 6.5% from last year and diluted EPS was \$2.27 for the quarter compared to \$2.29 last year. Free cash flow for the quarter was \$194 million and \$332 million year to date. We received \$1.2 billion in new contract awards resulting in backlog of approximately \$20 billion at the end of the quarter of which \$12 billion is funded.

Now let me share a few operational highlights. At Ingalls DDG-113 John Finn successfully completed Alpha builders trials, the first Arleigh Burke Class C trials in nearly six years. In addition, strong NSC program performance continues as NSC 6 Munro successfully completed acceptance trials. Both ships are expected to deliver by the end of the year.

Importantly, Ingalls was awarded two contracts for design work on the amphibious warfare ship replacement, the LX(R), a new class of ships we are well prepared to build with a hot production line and mature learning curve given the hull form for this new class of ships is the same as the LPD class. Ingalls also won a competitively big contract to overhaul the destroyer DDG-61 USS Ramage.

At Newport News, CVN-784 is essentially complete, with less than 10% of the overall test program remaining to be completed. We are prosecuting the repairs on the main turbine generators and moving towards sea trials and delivery as efficiently as possible. This program, albeit challenging, has demonstrated great teamwork by our shipbuilders, our customer, and the forge crew, and I am very proud of that collaboration, and I'm very proud of that ship.

Newport News also was awarded a \$195 million contract modification for continued advance planning for the refueling and complex overhaul of CVN-73 George Washington. On submarines, the Virginia-class team continues to prepare for an early to contract delivery of SSN-787 Washington, the second Block III submarine delivered by Newport News, and the 14th submarine of the Virginia-class. And we look forward to the Navy's milestone B decision on the Ohio replacement program set for later this month.

Now I want to shift for moment and address two recent announcements related to our path to 2020 strategy. First, our Board of Directors approved a 20% increase in our quarterly dividends to \$0.60 per share. This reaffirms our commitment for the dividend increases of at least 10% annually.

Second, we announced the acquisition of Camber Corporation and the establishment of our technical solution segment, an organizational change that consolidates our services subsidiaries under a single reportable segment. One of the key tenets of our strategy is to optimize and expand our services portfolio. The acquisition of Camber and the establishment of our technical solution segment enables us to do just that.

We are very excited about the Camber acquisition and are pleased to welcome their 1700 employees to the HII family. Camber, based in Huntsville, Alabama, and with a significant presence in the Washington DC area, provides sophisticated mission-based professional services and high-end IT solutions to a wide range of US government customers. These customers include the Navy, Army, Marine Corps, the US court system, the Postal Service, and the intelligence community.

We are already teaming with Camber in support of the US Navy, so we are familiar with their personnel and culture and believe it will be a great fit with us together. Their highly qualified and professional workforce, broad array of high-end capabilities and long-term customer relationships provide numerous opportunities to strengthen our position in government services and capitalized on our existing AMSEC franchise.

In addition, their prime position on several large contract vehicles coupled with AMSEC's provide the combined companies the ability to compete for work previously only accessible as a subcontractor. Camber will be a foundational component of our new technical solutions segment, a roughly \$1 billion segment that will also include our AMSEC, Continental Maritime, SN3, Newport News Industrial, Undersea Solutions Group, and UniversalPegasus business.

We believe that the establishment of this new division will not only create a strategic focus on these businesses, but will also improve performance transparency. We anticipate topline growth for this business in the low single digit range in line with the outlook for government services budget and operating margin expanding from low single digits in 2017 to the 5% to 7% range by 2020.

So in closing, this quarter's results at Newport News demonstrated the volume and margin pressure that we talked about on the call last quarter. However, given the strong performance at Ingalls we still expect total Company sales to be essentially flat and margins to be in the 9% to 10% range for the full year. We remain focused on program execution, risk retirement, and cash generation in order to create long-term, sustainable value for our shareholders. We also look forward to the closing of the Camber acquisition by the end of year and integrating Camber and the other subsidiaries into the technical solutions segment.

That concludes my remarks, and I will now turn the call over to Chris Kastner for some remarks on the financials.

Chris Kastner - *Huntington Ingalls Industries Inc. - EVP of Business Management and CFO*

Thanks Mike, and good morning. Today I will review our third-quarter consolidated and segment results, as well as provide you with a few updates for the full year. But first, I'd like to walk you through the transaction summary for our acquisition of the Camber Corporation starting with slide 4 of the presentation.

As Mike mentioned, we signed a definitive agreement to acquire Camber for \$380 million. The purchase price includes approximately \$25 million of tax benefits. The purchase price net of the tax benefit represents a multiple of 8.6 times Camber's adjusted EBITDA for its fiscal year ended June 30, 2016. We plan to fund the transaction with cash from the balance sheet, which at the end of the third quarter was \$957 million, and we anticipate that the deal will close by year end. Camber generates low double digits to EBITDA margin with low capital investment and we expect the transaction to be accretive to cash flow and earnings per share in 2017.

Moving on to our consolidated results on slide 5 of the presentation, total revenues for the quarter were \$1.68 billion, a decrease of \$117 million, or 6.5% from third quarter 2015. The decrease was primarily due to lower volumes at Newport News, and to a lesser extent lower volumes at Ingalls.

Total operating income for the quarter was \$175 million, a decrease of \$25 million, or 12.5% from the third quarter last year. Total operating margin was 10.4%, a decrease of 71 basis points from the same period last year. These decreases were driven by lower volumes and risk retirements at both Ingalls and Newport News, and partially offset by the favorable FAS/CAS adjustment.

Turning to slide 6 of the presentation, cash from operations was \$254 million and free cash flow was \$194 million for the quarter. Capital expenditures for the quarter were \$60 million, or 3.6% of revenues compared to \$37 million or 2% of revenues in the third quarter last year.

Year-to-date capital expenditures are \$105 million, or 2.8% of revenues, and for the full year we now expect capital spend to be between 4% and 4.5% of revenues. Additionally, we purchased approximately 407,000 shares at a cost of \$68 million and paid dividends of \$0.50 per share or \$22 million.

Moving on to segment results on slide 7 of the presentation, Ingalls revenues for the quarter were \$577 million, a decrease of \$16 million, or 2.7% from the third quarter last year. The decrease was driven by lower volumes on the LPD and NSC programs, which were partially offset by higher volume on the DDG program. Operating margin of 11.4% for the quarter decreased 155 basis points from the same period last year due to lower risk retirement on the LHA program.

Turning now to Newport News on slide 8 of the presentation, revenues for the quarter were \$1.1 billion, a decrease of \$105 million, or 8.9% from the third quarter last year due to lower volumes on aircraft carriers and the VCS program. Operating margin was 7.4% for the quarter, a decrease of 113 basis points from the same period last year due to lower risk retirement on the VCS program, as well as a Q3 2015 resolution of outstanding contract changes on the CVN-71 RCOH.



With respect to the other segment on slide 9 of the presentation, revenues for the quarter were \$33 million, an increase of \$3 million or 10% from third quarter last year due to higher volumes in the oil and gas services market. Operating loss for the third quarter was \$5 million, consistent with the operating loss in third-quarter 2015.

Now for some updates on the full year on slide 10 of the presentation. We're now estimating a FAS/CAS adjustment of approximately \$145 million for 2016, which is slightly higher than our previous estimate as a result of updated census data. Additionally, we now expect deferred state income tax expense of approximately \$10 million for the year, which is at the lower end of our previous year range. For the full year, we still expect interest expense of approximately \$75 million, and our effective tax rate to be between 30% and 32%.

Now for a status update on Avondale, during the third quarter we received a response from the customer regarding our request for a final decision on the restructuring costs for Avondale. The customer informed us that a final decision would be issued before the end of the year. Therefore, I should be able to provide you with another update on our year-end call.

I also want to share with you our initial thoughts on pension for 2017. The discount rate we use to value our pension liability has gone down approximately 80 basis points from the rate at the beginning of year which was 4.73%. Given today's low interest rate environment and the final phasing in of harmonization in 2017, we expect both FAS expense and CAS cost to be higher next year. As a result, the FAS/CAS adjustment for 2017 is expected to be more favorable than 2016.

From a cash perspective, while pension contributions are expected to increase as a result of lower interest rates, our net pension cash position after CAS recoveries should remain positive in 2017. Remember, pension is a very complex subject that is impacted by numerous factors, so it is important to not get too specific until we have more clarity around the variables. As such, I will provide you with more details on the 2017 FAS/CAS adjustment and our 2017 cash contributions during our year-end call.

That concludes my remarks. I'll turn the call back over to Dwayne for Q&A.

QUESTIONS AND ANSWERS

Dwayne Blake - *Huntington Ingalls Industries Inc. - VP of IR*

Thanks, Chris. As a reminder to everyone on the call, please limit yourself to one initial question and one follow-up so we can get as many people through the queue as possible. Sonia, I will turn it over to you to manage the Q&A.

Operator

Thank you.

(Operator Instructions)

Jason Gursky, Citi.

Jason Gursky - *Citi - Analyst*

Good morning, everyone. Mike -- I guess everyone there, if you could dive a little bit deeper into the most recent acquisition, talk a little bit about any kinds of revenue synergies that you might see over time. And then talk a little bit about the past forward on the margins and what's going to allow for the margin expansion in this new division over the next couple of years as you laid out in your prepared remarks?

Mike Petters - *Huntington Ingalls Industries Inc. - President and CEO*

Sure. First of all, we are very excited that we've been able to execute this transaction. Camber is a government services provider. They provide pretty high-end mission-based services and high-end IT solutions. They have a large Navy presence. We actually team with them on some opportunities with the Navy through our AMSEC subsidiary.

But they also have access to other customers, the armies, the intel community, some other parts of the government that frankly some of the capabilities that AMSEC has could be deployed toward those customers and in return some of the customers that AMSEC has, like NAV-C could have access now. We can have more access for Camber to reach into that.

I think in a broader sense, these two businesses together have an opportunity to pursue new customers that neither one of them could pursue on their own. We are excited about that. We think that -- we think that they are just a great strategic fit and frankly the initiative for this acquisition came from inside the business unit. It is the folks on the deck plate that came and kind of suggested this and we took off -- we had been looking at this for quite a while and we got it to work out, consistent with the discipline that we laid out in front of you a year ago.

Beyond that, we have learned a lot from the acquisitions that we done. One of the key things that we have learned is that the pace of the services business is very different than the pace of our normal shipbuilding business. I think we kind of knew that from our government services already, but I think that now that we have the scale with Camber and AMSEC, SN3, and NNI, we put all of those together, we now have the scale to focus on that business in a way that will allow for the pace of the business to be consistent with what is required to be successful in the services business.

And it gives us an opportunity to create some growth in our -- for the Corporation. Our shipbuilding business has been -- from the beginning of the spin, we have been talking about the shipbuilding business as basically a flat business. We continue to kind of talk about that today, although there may be some opportunities ahead of us.

But now we actually have access to a little bit more of the normal natural growth progression in the government services field. And so all of that is very exciting to us. The creation of a third business unit will create a lot of transparency.

Transparency is a double-edged sword for sure. You will get to see a lot of what is happening, good and bad. You know, we've got some work to do to get that entire business segment to a place where the margins are in the normal range and we think the normal range is in the 5% to 7% area.

When you first see this come out there is going to be all of the puts and takes of a whole lot of different kinds of businesses there. UPI is going to be in there, Continental will be in there, and so we'll be, as Chris pointed out, low single digit margins with an opportunity to expand those over the next three to five years. We think it is a reasonable approach for us to take to expand the capability of the business, to expand again our customer set, and create access for unique capabilities on the high-end side of the services business to a new set of customers that makes great sense for us and we hope will make great sense for our customers.

Jason Gursky - *Citi - Analyst*

That's great. Chris, can you just comment really quickly on the margin expansion and the source of that margin expansion at a new business?

Chris Kastner - *Huntington Ingalls Industries Inc. - EVP of Business Management and CFO*

Sure. Initially the low margins, as Mike indicated, are a result of UPI being in the mix and being challenged coming out of the gate and then some investments we're making in the DOE space for SN3. Naturally as UPI recovers and we are successful in our initiatives relative to SN3, you should get a margin lift there. Camber and AMSEC performed very well already. We just need to ensure that we continue that performance.



Jason Gursky - Citi - Analyst

Got it. That makes sense. Thanks, guys.

Operator

Gautam Khanna, Cowen and Company.

Gautam Khanna - Cowen and Company - Analyst

Thanks, good morning, guys.

Chris, I was wondering if you could just get into a little bit more color directionally on the pension. You mentioned FAS/CAS is actually going to be up next year. Could you give us any sense for what the increase in cash contributions will be for the plan next year, discretionary to keep the 90%?

Chris Kastner - Huntington Ingalls Industries Inc. - EVP of Business Management and CFO

It is a little early for that, and I know you're frustrated with that answer. I will be able to give you that at the year end call. But I wanted to give you some indication that net cash would be positive and at a similar level plus or minus \$20 million from where we are this year from a net cash standpoint.

Gautam Khanna - Cowen and Company - Analyst

Okay, that's not terrible by any means. You mentioned you did this deal obviously with Camber. Is there any change to the cash deployment strategy in terms of deploying 100% or free cash for dividends and buybacks, or how should we think about the M&A strategy as you (multiple speakers)?

Chris Kastner - Huntington Ingalls Industries Inc. - EVP of Business Management and CFO

It's a good question. It actually enhances it because there's going to be more free cash to be distributed to shareholders. So we're using cash on the balance sheet to do this. We're still committed to investing in our shipyards; \$1.5 billion over the next five years, and we told you about our dividend at the 20% increase earlier this week. And we're still committed to at least a 10% increase over the next four years, and will evaluate that as we come to our plans for those years. But really no change to the strategy. It just provides more cash flow for shareholders.

Gautam Khanna - Cowen and Company - Analyst

Okay, and the last one, maybe Mike, can you update us on what the milestones we should be tracking for the Ohio class are?

Mike Petters - Huntington Ingalls Industries Inc. - President and CEO

Yes, there's a major milestone coming up this month we think that will kind of cut loose a lot of the contracting. I think the real question on Ohio class continues to be how the funding is going to work out.

You know, the business arrangement has been worked out. Our partners at General Dynamics in the Navy, we've got that all sorted out. We know exactly the path ahead, now it's just a question of can we get through the -- can we get the funding straight and can we get out of the sequestered environment that's kind of keeping a potential for a wet blanket on all of our plans.

That to me is the real big thing to pay attention to. The mechanisms inside the Pentagon are on track.



Gautam Khanna - *Cowen and Company - Analyst*

Thanks a lot guys.

Mike Petters - *Huntington Ingalls Industries Inc. - President and CEO*

You bet, thank you.

Operator

Sam Pearlstein, Wells Fargo Securities.

Sam Pearlstein - *Wells Fargo Securities - Analyst*

Good morning. Chris, can you talk about the -- you said you're funding this acquisition with cash on hand. How should we think about how much cash you need to hold on the balance sheet to run the business? Because it looks like you have been \$900 million to \$1 billion in cash for four or five years now, so are you now going to be able to run at a lower level?

Chris Kastner - *Huntington Ingalls Industries Inc. - EVP of Business Management and CFO*

Yes. I'm comfortable between \$500 million and \$600 million on the balance sheet and even beneath that. We have a revolver in place that I really would not want to tap in for operational issues, but our balance sheet is very healthy and I am comfortable at the \$500 million to \$600 million level for sure.

Sam Pearlstein - *Wells Fargo Securities - Analyst*

Okay, and then the capital spending increase this year in terms of just the percentage of sales. Is this timing? Have you pulled things forward from 2017, so that maybe 2017 is then a little bit lower? How should I think about it between the two years?

Chris Kastner - *Huntington Ingalls Industries Inc. - EVP of Business Management and CFO*

We have expected this strong capital expend in 2016 for a while. Remember it was 3.5% to 4.5% as we started the year and we're drifting between 4% and 4.5% now. We think that 2017 is going to be a strong year for capital.

All these initiatives are started. I drove by the north yard last week and a lot of activity, preparing for the ORP program, a lot of work going on down there. So these major projects have been initiated, and I expect significant capital not only this year but next year.

Sam Pearlstein - *Wells Fargo Securities - Analyst*

Okay. And one last question is just on the Board. Is there any way to think about -- are there any financial implications of the delay in the acceptance there?



Chris Kastner - *Huntington Ingalls Industries Inc. - EVP of Business Management and CFO*

We have re-phased our [issues] to reflect the work to go on the contract and there is a minor adjustment, not significant enough to mention within the quarter, that we have already taken into consideration.

Sam Pearlstein - *Wells Fargo Securities - Analyst*

Thank you.

Chris Kastner - *Huntington Ingalls Industries Inc. - EVP of Business Management and CFO*

You're welcome.

Operator

George Shapiro, Shapiro Research.

George Shapiro - *Shapiro Research - Analyst*

Yes, Chris, following up on Sam's question, the implication, though, is to even to get to 4% of sales for CapEx is the fourth quarter's got to be like \$130 million, which is almost as big as the first nine months put together. So I know the fourth quarter's always strong, but it's not usually that strong, so maybe you can just talk a little bit about why it is going to spike up so much?

Chris Kastner - *Huntington Ingalls Industries Inc. - EVP of Business Management and CFO*

Yes, there's some major investment going on at Newport News. As I said with the ORP program and significant invoices related to those buildings as well as the fixtures there. So always a couple invoices could slip into next year, but I look at this significant basis on a monthly basis and I fully expect to be between 4% and 4.5% for the quarter.

George Shapiro - *Shapiro Research - Analyst*

Okay. And one for you, Mike. How do you trade off making this acquisition, which is modestly accretive, but it would be a bigger accretion if you just used the cash to buy back stocks. How do you trade that off in your own mind?

Mike Petters - *Huntington Ingalls Industries Inc. - President and CEO*

Well, I think the first place I start with, George, is where is your horizon? I mean, this is a long-term business and we have a customer, our Navy customer, has a 30-year plan that we're trying to figure out how best to support it. We might be able to feel good about something we could do in what we would call the short-term, which is like three to five years.

But the real question is how do you build the right set of capabilities for this Company to partner and support all of our principal customers for the long term? So we have a plan today that is going to increase our dividends by 10% a year. We have a plan today that returns with the dividends and the stock buybacks. We're going to return all of our free cash flow to our shareholders over the next five years and we're going to do this transition without affecting that.

And as Chris pointed out, this transaction actually increases the cash flow. So, you know, there's a trade-off there, but I'm not sure it is really that hard to figure out which way we need to go, because we still have to keep our eye on a horizon that is pretty far away.



George Shapiro - *Shapiro Research - Analyst*

And then just to follow up on that, the future acquisitions I would assume will be more in this service area as opposed to the oil and gas?

Mike Petters - *Huntington Ingalls Industries Inc. - President and CEO*

Yes, sure.

This is consistent with what we said a year ago that we're going to execute in our core business, we're going to grow our services, and we're going to return all of our free cash to our shareholders. The oil and gas basis, I think that 10 years from now we are going to be glad we were in that space, but it has been pretty rocky for the past few years.

Right now if you -- even if you tried to do something over in that space, I think valuation becomes a crapshoot. We're not terribly interested in rolling the dice like that. But we are very proud to be in that business and we're proud of the work that we do in that space and we keep a close eye on it.

George Shapiro - *Shapiro Research - Analyst*

Okay, thanks very much.

Mike Petters - *Huntington Ingalls Industries Inc. - President and CEO*

You're welcome.

Operator

Doug Harned, Bernstein.

Finbar Sheehy - *Bernstein - Analyst*

Good morning. It's Finbar here for Doug.

Mike Petters - *Huntington Ingalls Industries Inc. - President and CEO*

Good morning.

Finbar Sheehy - *Bernstein - Analyst*

I'm wondering if you could just on the Newport News side you said that there's a lower volume on VCS Block III, which came sooner than the ramp up of volume on Block IV. Is that an accident of timing in the quarter, or is there more of a clear revenue dip in recovery pattern we should be thinking about as you transition between blocks?



Chris Kastner - *Huntington Ingalls Industries Inc. - EVP of Business Management and CFO*

You use the right word. It is transitional. So Block III to Block IV, CVN-72 to CVN-73 for the RCOH efforts, and then CVN-78 to CVN-79. So it's a gradual transition. We still expect it to be essentially flat over the next couple of years. That being said, we're rolling up our plans right now. We'll have some more visibility in that at our year end call.

Finbar Sheehy - *Bernstein - Analyst*

Okay. And to follow up on the services business and creating the new segment, you commented that the new segment would initially have fairly low margins and part of that is coming from margins that are currently showing up in the other segment. But does it also have implications that you would be moving low-margin work out the shipbuilding segments and possibly reporting them at a nominally higher level going forward?

Chris Kastner - *Huntington Ingalls Industries Inc. - EVP of Business Management and CFO*

Absolutely. You're going to get a lot more visibility into the shipbuilding margins directly related to shipbuilding. So part of the transparency is not only on our services segment, but the transparency that you get related to shipbuilding. So we're still committed to 9% to 10% return on sales in shipbuilding and I think that's the right margin for that business.

Finbar Sheehy - *Bernstein - Analyst*

Okay, thank you.

Operator

(Operator Instructions)

Peter Skibitski, Drexel.

Peter Skibitski - *Drexel - Analyst*

Good morning guys.

Chris Kastner - *Huntington Ingalls Industries Inc. - EVP of Business Management and CFO*

Good morning.

Peter Skibitski - *Drexel - Analyst*

I got on a bit late so I'm sorry if you addressed this, but the \$8.3 million nonrecurring expense and then the \$12.6 million intangible amortization, are both of those one timers in the fourth quarter and then go to zero in 2017? Or is the \$12.6 million flatish for a number of years? I'm just wondering how that works.

Chris Kastner - *Huntington Ingalls Industries Inc. - EVP of Business Management and CFO*

Yes, the \$8 million is definitely a one-timer. The \$12 million extends out for a while.

Peter Skibitski - Drexel - Analyst

Okay got it. And then on the Ingalls margins, as I look back to even back to 2014 on an adjusted basis, Ingalls has been in the -- really in the solid double-digit margin rates, so I'm wondering when we should start thinking of this segment in particular? It's kind of a 10% to 12% margin unit going forward, or has this been some type of secular issue that is going to abate soon? Or how should we think about that?

Mike Petters - Huntington Ingalls Industries Inc. - President and CEO

Yes, I think you should think about it as the latter. Only from the standpoint of if you look at where that business is, they're executing mature programs today and they're executing them very, very well. On the horizon is a new LXR program, there's going to be a new competition for the DDG program.

We're just getting started really right on the front end of LHA-8, which we just won this summer. There's a whole big discussion about an icebreaker program. So these new programs that are out there in the next -- in the five year time frame are kind of the cycle of the business. And a big part of what Ingalls has to do is go capture a lot of that work.

Clearly their performance that they have is going to help them capture that work, but they've got to go capture it. And then just like Newport News is going through a transition they will go through a transition, as well. They are benefiting right now from working -- doing really good work on what had been some pretty tough programs, and they are being rewarded for it.

Peter Skibitski - Drexel - Analyst

Okay, very helpful. My last one on Newport News on the margins this quarter, is that pretty much all related to the forward delay, or is it the lower volumes? And should we expect year to date you're around 8% or so? Is that the right level to be at until you're out of this transition period, which I can't remember if that is second half of 2017, or when we break out of that? Can you speak to that?

Chris Kastner - Huntington Ingalls Industries Inc. - EVP of Business Management and CFO

There was some broad-based pressure related to increased CAS cost at Newport News as well. So I would expect total shipbuilding to be between 9% and 10%. I really would rather not talk about individual yards return on sales performance.

Peter Skibitski - Drexel - Analyst

Okay, thanks guys.

Operator

Joseph DeNardi, Stifel.

Joseph DeNardi - Stifel - Analyst

This just goes back to a prior question, but Mike, you talked about a healthy margin being 9% to 10% when you strip out the services business, and what does that become going forward?

Mike Petters - *Huntington Ingalls Industries Inc. - President and CEO*

No, that's actually it's going -- we think that the healthy yard is 9% to 10%. We've been operating with services buried inside of Newport News for almost six years, which has been a pressure on Newport News in terms of the 9% to 10%. So stripping this out what you will see is our two shipbuilding segments.

I would love to be able to tell you that each of those segments would operate in the 9% to 10% range in a healthy way, but what you're actually seeing now is what we have been talking about. Newport News is going -- we've been talking about the transition at Newport News for quite a while now. These carrier deliveries that are coming up, and then the transitions that Chris mentioned, 78 transitioning to 79, 72 refueling transitioning to 73, the VCS Block III transitioning to Block IV, the startup of the ORP program.

Those transitions are happening at Newport News, which that puts them on the lower end of that range. On the other end, Ingalls is at the top end of the range, simply because they are executing very mature programs and they are doing it exceptionally well, and so between them today you see between the two units how what I think if we lived in the best of all possible worlds you would see that could happen inside of any particular shipyard.

We are just a little bit out of phase at Newport News right now, but we will work our way through that over the next 12 to 18 months. At Ingalls the question is business development. Can you go capture the new work that is out there and get it on time? And all of that is why we keep saying that you have to figure out how to get ORP funded, because if you try to take the ORP funding out of the Navy shipbuilding account, it's going to squeeze programs down and delay them, which will have effect in our shipbuilding business.

We think that is an industry-wide problem, it's not just an HII problem, but I think it is the number one issue facing the Navy shipbuilding account, and it's a subset of the major issue of what the heck are we going to do about sequestration, because we've got to get that fixed.

Joseph DeNardi - *Stifel - Analyst*

Yes, that's helpful. And then can you give us an update on CVN-79 just maybe in terms of percent complete at this point and just how the construction is going?

Mike Petters - *Huntington Ingalls Industries Inc. - President and CEO*

It's going really well. You know we set some pretty good budgets for our labor cost down there, and we're essentially meeting all of those.

Chris Kastner - *Huntington Ingalls Industries Inc. - EVP of Business Management and CFO*

It's a bit over 20% complete (multiple speakers).

Mike Petters - *Huntington Ingalls Industries Inc. - President and CEO*

That includes material procurement, but we're doing pretty well. We're hitting our targets there.

Joseph DeNardi - *Stifel - Analyst*

Great. And lastly, just on Camber and the services business going forward, mid single digit margins is okay. It's not particularly exciting. Are there any other financial metrics? I mean you talked about the business opportunities, but other financial metrics that you look at that gets you guys excited whether it be a return on capital, that type of thing?



Mike Petters - *Huntington Ingalls Industries Inc. - President and CEO*

I think we started last year. We told you that our shipbuilding businesses are return on sales kinds of business and our services businesses really need to be a return on capital business, and that is what excites us about this headline of 5% or 6% or 7% may not get you moving, but a return on the capital investment is minimal.

So it's really about people, it's about the intellectual property that they bring, and the relationships they have with their customers, and the ability to create cash at the bottom line for our shareholders, and that's what's exciting to us.

I'm excited that we actually were able to put together this transaction in a way that met the pretty disciplined guidelines that we laid out for you a year ago. You know, we're going to be creating more cash flow for our shareholders because of this transaction, and we're excited about that.

Joseph DeNardi - *Stifel - Analyst*

Great. Thanks, Mike.

Chris Kastner - *Huntington Ingalls Industries Inc. - EVP of Business Management and CFO*

I will say the capital requirements are less than 1% for that organization on a run rate going forward, so that when you think about the difference in how we look at the capital -- the investment returns, the capital requirements over there are very minimal.

Joseph DeNardi - *Stifel - Analyst*

Thank you.

Operator

(Operator Instructions)

Robert Spingarn, Credit Suisse.

Robert Spingarn - *Credit Suisse - Analyst*

Good morning. Mike, I wanted to ask a high level question as we talk about margins and with them performing so well at Ingalls lately in the double digits. When you have serial production in a program, and you referred to mature programs, should ship margins progress from ship to ship, or is there point at which you are sharing with your customer?

You've been very clear about the business being a 9% to 10% margin. Might we get to a situation where the margins contracted on the back end of a serial production run?

Mike Petters - *Huntington Ingalls Industries Inc. - President and CEO*

You could see that, Rob, if you define the serial production lines being across several contracts, you know. Like the submarine program has had multi-ship contracts -- Block III was several ships, now Block IV is several ships.



When you go and you do a new contract in that you are -- in a sense, you're not resetting back all the way to the beginning of the program, but you are resetting the relationship between the customer and the industry from a performance standpoint. And how you did on the last contract definitely influences the way that contract looks, and that's why we kind of as we transition into these programs at the beginning of the contracts we become pretty conservative again.

You know, the last ship of Block III we expect to do really well; the first ship of Block IV we're going to be pretty conservative on. You know that's just the way we do it and I think that that's indicative of the way the business arrangement with our customer works. And I think that, you know -- I think that's probably how you could see that.

You know, in the normal course of business inside of a single contract you should, if you have a multi-ship contract, you should see much better performance at the end of that program than you see at the beginning of that program.

But then when you go and reset it for the next contract, you're going to start all over again.

Robert Spingarn - *Credit Suisse - Analyst*

So that makes sense. So on a multi-year or multi-ship contract we think of all the ships in there as kind of the same way we would think of a single ship on a single ship contract?

Mike Petters - *Huntington Ingalls Industries Inc. - President and CEO*

Right. That's right. (Multiple speakers). The multi-year that we have with the DDGs, for instance, that will be another -- not only will we reset based on performance, but we're going to go compete it again. So that creates a whole new set of performance parameters for that next multi-year.

Robert Spingarn - *Credit Suisse - Analyst*

But like on the LPDs it would be one at a time, so there it would be a different dynamic?

Mike Petters - *Huntington Ingalls Industries Inc. - President and CEO*

Right. When you're only doing one ship on the contract, you know, your opportunity -- the mistakes that I have seen and been involved with in my career have been where you have one ship following, you know, you do an LPD and then you do another LPD, or you do a carrier and then you do another carrier. And you get out in front of your headlights in terms of risk retirement on the second ship before you've actually retired the risk.

I think that's the real problem that you have with the one ship contracts is you can get out in front of yourself if you're not careful. Our system and our approach that we've adopted is fairly conservative, and we do our best not to get out in front of ourselves on those single-ship contracts.

Robert Spingarn - *Credit Suisse - Analyst*

Okay. That's all I have.

Mike Petters - *Huntington Ingalls Industries Inc. - President and CEO*

As an example on the 79, we're hitting our milestones on the 79 and we're pleased with progress there, but we're not about to take a victory lap on it, because we still got 80% of that ship to go. And we're going to be pretty conservative because we have good sense of all the things that could not be retired between now and the delivery of the ship.

Robert Spingarn - *Credit Suisse - Analyst*

Okay, thanks Mike.

Operator

(Operator Instructions)

I am showing no further questions. This does conclude our question and answer session. I would now like to turn the call back over to Mike Petters for any further remarks.

Mike Petters - *Huntington Ingalls Industries Inc. - President and CEO*

Thanks everybody for joining us today and thanks for your interest in our Company. We continue to be consistent with what our path to 2020 strategy is. We're going to execute in our core business, we're going to continue to grow our services, we think that that's going to generate more cash for our shareholders and more value for our Company.

And so we're excited about the recent announcements and transaction and we're really excited about the future of this business. We thank you for joining us today, and we look forward to seeing you.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This completes today's program. You may all disconnect. Everyone have a great day.

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