Leidos Holdings, Inc. (LDOS)

Information Technology – Defense Contractor

Stock Rating | BUY
---|---
Target Price | $115-125

**Investment Thesis**

We recommend a BUY rating for Leidos Holdings, Inc. (LDOS). Leidos engages in providing science, engineering, and information technology services and solutions through the Defense Solutions, Civil, and Health segments for both government and commercial consumers. The 11.8% compound annual growth rate of its revenue in the last 5 years implies that it is still in the growth stage of the business life cycle. In addition, the recent acquisitions broadened its product lines. As of April 2021, our target price implies an upside of 14-24%. Therefore, we recommend a BUY rating.

**Drivers of Thesis**

- The total revenue grew by 10.84% during the pandemic. We estimate it to grow by 8.9% in 2021, gradually slow down and stabilize around 4.3% in the long run.
- The work-from-home trend seems to last even after the pandemic, which means that the need for reliable IT and cybersecurity services will continue to grow.
- The recently completed $214 million acquisition of 1901 Group greatly enhanced Leidos’ ability to deliver clouding, cybersecurity, and IT services solutions.
- Leidos stands out among competitors because of the $21.7 billion contract awards.

**Risks to Thesis**

- Over 90% of the Leidos’ revenue is generated from government contracts. Any volatilities in the government’s budget will hurt the company heavily. Many of their contracts have been or are going to be delayed.
- Being a contractor requires Leidos to comply with complex procurement rules and subject to audit by the government. The contracts can be terminated at any time. The company may get paid for the preparation it has made, or only get paid for the items the government is willing to accept.
- To win contracts, Leidos needs to attend the bidding process, which requires a large amount of time and money. The potential protests can make contracts delayed or even canceled.

**Drivers of Thesis**

- The total revenue grew by 10.84% during the pandemic. We estimate it to grow by 8.9% in 2021, gradually slow down and stabilize around 4.3% in the long run.
- The work-from-home trend seems to last even after the pandemic, which means that the need for reliable IT and cybersecurity services will continue to grow.
- The recently completed $214 million acquisition of 1901 Group greatly enhanced Leidos’ ability to deliver clouding, cybersecurity, and IT services solutions.
- Leidos stands out among competitors because of the $21.7 billion contract awards.

**Risks to Thesis**

- Over 90% of the Leidos’ revenue is generated from government contracts. Any volatilities in the government’s budget will hurt the company heavily. Many of their contracts have been or are going to be delayed.
- Being a contractor requires Leidos to comply with complex procurement rules and subject to audit by the government. The contracts can be terminated at any time. The company may get paid for the preparation it has made, or only get paid for the items the government is willing to accept.
- To win contracts, Leidos needs to attend the bidding process, which requires a large amount of time and money. The potential protests can make contracts delayed or even canceled.

**Earnings Estimates**

<table>
<thead>
<tr>
<th>Year</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
<th>2021E</th>
<th>2022E</th>
<th>2023E</th>
</tr>
</thead>
<tbody>
<tr>
<td>EPS</td>
<td>$3.85</td>
<td>$4.66</td>
<td>$4.42</td>
<td>$5.19</td>
<td>$5.95</td>
<td>$6.57</td>
</tr>
<tr>
<td>HF est.</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>$4.74</td>
<td>$5.27</td>
<td>$5.67</td>
</tr>
<tr>
<td>growth</td>
<td>59.75%</td>
<td>21.04%</td>
<td>-5.15%</td>
<td>7.24%</td>
<td>11.18%</td>
<td>7.59%</td>
</tr>
</tbody>
</table>

**12 Month Performance**

Leidos Holdings operates through Defense Solutions, Civil, and Health segments in Defense Contractors sector. With a market capitalization of $132.33 billion, Leidos earns the 4th position in this sector. About 82% of its total revenue is generated from this sector. In general, more than 90% of its revenue is earned within the United States by cost-reimbursement type of contract. Their primary clients including the Department of Defense, the Intelligence Community, and other government departments and agencies.
COMPANY DESCRIPTION

As shown in the below chart, Leidos operates through Defense Solutions, Civil, and Health three segments to provide integrated services and solutions for both domestic and international clients. The Defense Solutions segment mainly concentrates on business modernization, airborne capabilities enhancement, and cybersecurity. The Civil segment primarily focuses on researching and supporting the building of modern infrastructure. The last segment Health aims at improving people’s wellbeing and providing cost-effective solutions for both government and corporate consumers.

![2020 Leidos Segment Revenue](chart)

**Defense Solutions**

The Defense Solutions segment aims to satisfy clients’ ever-changing missions with advanced and leading IT services and solutions. In specific, the primary areas Leidos focuses on airborne, modernizing IT services, autonomous solutions, operations-logistics, cybersecurity, and command-control.

- C4ISR Technologies and Services — Leidos concentrates on airborne and ground intelligence, surveillance and reconnaissance, sensor and autonomous systems. The U.S. Intelligence Community, DoD, and military services are the major customers.
- Transformative Software, Analytics — Leidos helps the U.S. government and its allied governments to build advanced software and IT systems for complex data-driven threats.
- Intelligence Analysis, Mission Support and Logistics Services — Leidos provides optimization and modernization solutions for the U.S. and the key allies’ supply chain. Major clients include the U.S. Intelligence Community, DoD, and key allies.

As the biggest segment of Leidos, Defense Solutions represents 60% of the total revenues in the past year. It increased 16.5% in 2020, which was led by the acquisition of Dynetics and newly awarded contracts. Its growth is closely tied to the defense budget. There are pressures from Democrats that urge the president to reduce the defense budget. They argued that we can acquire greater returns by investing in public health, diplomacy, and humanitarianism. However, Republicans and conservative Democrats argue that to stay ahead of competitors, the U.S. needs to increase the defense budget significantly. The early planning indicates that there will be neither growth nor big cuts for the first Biden defense budget.

The projected defense budget is about $700 billion. Besides, the recent acquisition activities, contract awards, and the segment performance during the pandemic are all the reasons why we hold an optimistic attitude towards future growth.

The segment revenue growth is relatively stable in recent years, as of the end of fiscal 2020, the 5-year CAGR is 13.8%. We forecast a 11% growth in Defense Solutions revenues in 2021. The growth rate will decrease by 1% per year through 2026, and then decrease by 0.2% per year through 2028, and finally reach the stable stage in 2029 with a 4.5% growth rate.

**2020 Leidos Geographic Revenue**

- United States: 91%
- International: 9%

Source: 2020 Leidos Holdings, Inc. 10K

Generally, less than 10% of the total revenue is generated from foreign countries. Specifically, 5.5% and 2.7% of its total revenue were generated from the United Kingdom and Australia respectively in 2020. Typically, defense contractors like Leidos need to get the pre-approval by the contracting officers before conducting international businesses. Although the remaining part is from domestic businesses, it represents a -0.3% decrease as compared to 2019.
Civil

The Civil segment focuses on helping clients improve efficiency by implementing infrastructure, system, and security modernization. It represented 24% and 25% of total revenue in 2020 and 2019, respectively. The core customers include FAA, DOE, NASA, and airports.¹

- Transportation Solutions – Leidos provides air traffic control systems for FAA and other countries like New Zealand and South Korea. The key services including data management and automation modernization.¹
- Security Detection and Automation – by applying screening technology, artificial intelligence, and machine learning, Leidos helps worldwide clients to increase the security for aviation, ports, and borders. The key domestic client is the U.S. Customs and Border Protection.¹
- Digital Transformation Services – Leidos assists FAA, NASA, and the Department of Justice to modernize enterprise IT systems.¹

During the pandemic, Civil revenues increased $198 million, which represents a 7.1% increase compared to the prior year. This was primarily due to the acquisition of L3Harris Technologies Security Detection and Automation businesses and contract wins. The acquired businesses provide screening products for airports and key infrastructures.⁹ With this acquisition, Leidos now deploys more than 24,000 related systems in more than 120 different countries. Thus, we hold the opinion that this segment is competitive within this industry.¹²

This segment revenue has a 5-year CAGR of 7.54%. We forecast the Civil segment revenue will grow by 8% in fiscal 2021. The growth rate will decrease by 1% through fiscal 2024, and then decrease by 0.2% for 2 years, stabilize at 4.5% in 2027 and thereafter.

Health

With integrated IT and scientific services, the Health segment aims to improve people’s well-being by providing cost-effective services and solutions to government and commercial clients. It takes 16% and 18% of total revenue in 2020 and 2019.¹

- Health Information Management Services – Leidos provides single and common health records to DoD and VA hospitals and ensures cybersecurity in the meantime. Leidos also provides cost-effective IT solutions to the VA, NIH, DoD, and many other federal consumers.¹
- Digital Transformation – Major clients include Food and Drug Administration, VA, and Defense Health Agency. Leidos serves them with IT modernization and transformation, database management and analytics.¹
- Life Sciences Research & Development – Leidos supports the NIH, Center for Disease Control, Army Medical Research Community, and other corporate clients. The major areas are genetics and genomics, biomedical, and biopharmaceutical development.¹

There also exists an upward trend in Health segment sales, but it is not as strong as the other two segments. The CAGR from 2016 to 2020 is 11.93%. The Health segment is the only segment that has a negative revenue growth rate last year. The segment revenue of $1.96 billion represented a 1.8% decrease compared to that of 2019. Many contracts have been delayed by COVID-19, although the positives brought by the acquisition of IMX partially offset some
negatives, the downside pressure still dominated the growth last year. But now, the pandemic is relatively under control, and the vaccination rate continues to increase (~40%). As we mentioned earlier, the Democrats are asking the president to increase spending on public health. Overall, we hold a positive attitude about the recovery of this segment. But as Leidos did not announce any intents to acquire companies within the health industry, we do not think the growth rate can exceed the other two segments.

We project the growth rate in fiscal 2021 to be 6% and decrease by 0.5% every year through 2027. At that time, it will stabilize at 3% thereafter.

Source: Leidos Holdings, Inc. 10K

Cost Structure Analysis

As shown below, Leidos has five major operating expenses: Cost of Revenues (91%), General & Administrative (5%), Depreciation & Amortization (2%), Bid & Proposal (1%), and Research & Development (1%).

Source: Henry Fund Model

Cost of Revenues

As the biggest component of the operation expenses, Leidos does not provide details about it. From its 10k, we learned that some indirect costs associated with the government contracts and lease costs are included in the cost of revenues. Its weight (as the percentage of total sales) fluctuated during the last 10 years. Due to the lack of knowledge and the assumption of no major changes will happen, we decided to use the historical average (-85.53%) to estimate it in the projection period.

General & Administrative

The G&A expenses also fluctuated a lot in the last 10 years. It increased at first and then decreased. In most years, the percentage (% of sales) was around -4%. Similar to the cost of revenues, Leidos does not provide description for it. We expect the percentage to be -4% in the projection period.

Depreciation & Amortization

We estimate the depreciation expenses based on the implied depreciation rate we calculated (depreciation expense/beginning net PP&E). The final number we got is -30%. As for the amortization expense, we followed the company’s guidance.

Bid & Proposal

The percentage of Bid & Proposal expenses are relatively stable in recent years. It fluctuated around -1.3%. Based on it, we decided to use the historical average percentage (-1.3%).

Research & Development

Research and Development expenses are critical for Leidos’ development. R&D activities are funded by both customer contracts and company funds. One thing to notice here, any technologies created during the contract period or by using the government equipment belong to the government.

Leidos does not directly list R&D expenses on Income Statement, instead, it is a sub-category under Selling, General & Administrative expenses. Historically, it takes about -0.6% of total revenues. We forecast it to stabilize around the historical average level of -0.61%.
Leidos entered unsecured revolving credit, senior unsecured term loan, and bridge loan facilities in 2020. Furthermore, Leidos issued and sold senior notes mainly for repaying debt and implementing acquisition activities. Based on current data and estimation, we anticipate that Leidos is able to meet all the liquidity needs in 2021.

### ESG Analysis

According to Sustainalytics, Leidos is ranked at the 16\textsuperscript{th} position out of the 795 companies within the Software & Services industry, which represents a medium exposure to different material ESG issues and a strong management of its relevant ESG issues.\(^2\)

**Leidos Holdings, Inc.**

**ESG Risk Rating**

<table>
<thead>
<tr>
<th>ESG Risk Rating</th>
<th>Industry Group</th>
<th>Country</th>
<th>Ranking</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low Risk</td>
<td>Software &amp; Services</td>
<td>United States</td>
<td>16 out of 795</td>
</tr>
</tbody>
</table>

**Source:** Sustainalytics\(^2\)

As indicated below, LDOS and CACI fall into the low-risk group based on the ESG scores, BAH falls into the medium-risk group, and GD falls into the high-risk group. The information of PRSP and MANT is not available.

- Based on the 2010 greenhouse gas emissions level, Leidos set the goal to reduce the GHG emissions by 25% no later than 2020. And it achieved the goal 6 years ahead of the target.
- More than 40% of the $4.1 billion sourcing expenses went to domestic small businesses.
- In addition, Leidos hires veterans, educates employees, enhances ethics programs, and participates in the community in its day-to-day activities.

### Debt Maturity Analysis

As of January 1\textsuperscript{st}, 2021, Leidos had $524 million cash and equivalents. The total outstanding debt was $4.7 billion.
operation.\textsuperscript{19}

\begin{center}
\begin{tabular}{|c|c|c|c|}
\hline
 & LDOS & CACI & BAH & GD \\
\hline
ESG & 13.9 & 18.4 & 22.4 & 37.6 \\
\hline
\end{tabular}
\end{center}

Source: Sustainalytics\textsuperscript{25} (PRSP, MANT, SAIC not included, information not available)

\section*{ECONOMIC OUTLOOK}

\subsection*{Real Gross Domestic Product}

Real GDP is a non-biased inflation-adjusted measure of the value of economic outputs. As the following chart shows, it decreased 3.5\% from 2019-2020. Although the growth rate in 2020 Q4 is substantial, it is the outcome of ongoing restrictions brought by the pandemic that offsets the continuing economic recovery. As the vaccination rates going up, the Henry Fund team expects to see a 5.17\% growth in the next 6 months, and gradually return to the pre-pandemic level. Leidos almost entirely relied on the government contracts, during the pandemic, many of these contracts have been or are probably going to be delayed by the government as the priority changes. With a relatively stable real GDP recovery rate, we believe there will be fewer volatilities for ongoing and future contracts.

\subsection*{Treasury Yields}

We chose to use the 20-year Treasury Yield here as we estimated the risk-free rate based on it. As we can see in the chart below, the market has experienced a low-interest rate environment in the past 2 years. The lowest point was in March 2020, which was the outbreak of the pandemic. This environment did help companies who want to accomplish M&A activities. Leidos acquired IMX Medical Management Services, Dynetics, L3Harris, and 1901 Group during these periods.\textsuperscript{1} As we mentioned before, it took advantage of the low interest rate by entering different debt facilities for repaying debts and conducting acquisition activities. However, both Henry Fund’s assumption and the yield curve showed the rebound tendency. As the cost of borrowing will increase, we expect it to adversely affect Leidos’ M&A activities and the cost of capital.

\subsection*{Unemployment Rate}

From 2007 to 2021, the United States unemployment rate hit the lowest point 3.5\% in March 2020 and reached the peak of 14.7\% in May 2020. The volatile unemployment rate hurt the company as government needs to spend more to support unemployed people. As indicates in the following chart, although the unemployment rate has dropped to 6\%, which means that the economy is continuing to recover, there is still a long way to go back to the pre-pandemic level. The Henry Fund team estimates it to decrease to 5.59\% in the short run and 4.79\% in the long run. By having a lower unemployment rate, we are concerned about the potential increase in the mean wage, which will hurt Leidos’ margins.

\begin{center}
\begin{figure}
\centering
\begin{subfigure}{0.49\textwidth}
\centering
\includegraphics[width=\textwidth]{real_gdp.png}
\caption{Real GDP: Percent change from preceding quarter}
\end{subfigure}
\begin{subfigure}{0.49\textwidth}
\centering
\includegraphics[width=\textwidth]{20-year_treasury_yield.png}
\caption{20-year treasury yield (\%)}
\end{subfigure}
\end{figure}
\end{center}

Source: U.S. Department of the Treasury\textsuperscript{7}

Source: Bureau of Economic Analysis\textsuperscript{6}
Being as a government contractor, Leidos’ development relies heavily on the defense budgets. There was a sharp budget reduction followed the record high Department of Defense budget of $691 billion in 2010. Until the Bipartisan Budget Act of 2018 became effective, the modified spending caps improved the DoD budget. The budget level rose by 4.5%, 10.7%, and 2% in 2017, 2018, and 2019, accordingly. The 2019 budget level has increased to $685 billion, and it is projected to grow by 3% in 2020 to $705 billion thereafter. The defense budgets carry a relatively stable growth rate in the next few years. Thus, we hold a positive attitude.

COVID-19

As the response to the pandemic, Leidos has formed a multi-functional working group to monitor and response. Leidos also took steps to allow work remotely and ensure working environment safety. The company also created a COVID-19 guidance recommending the right time to return to work. Leidos’ airport security detection and automation business has been adversely impacted as the demand for flights has been decreasing for a while.

As compared to fiscal 2019, the COVID-19 adversely impacted revenues and operating income by about $198 million and $96 million, respectively. As of January 1, 2021, Leidos has deferred $123 million of employer social security tax payments and received $12 million from the Employee Retention Credit.

2020 Q4 Earnings Release

Comparing to the prior year’s Q4, the 10.1% increase led to a $3.25 billion revenue, which missed the consensus by $140 million. It includes $300 million and $89 million which is related to the acquisitions of Dynetics and L3Harris SD&A businesses. There was an 8.7% increase in quarterly diluted EPS for common shareholders, the $1.37 EPS beats the consensus by $0.07. Leidos generated $1.93 billion in revenue from the Defense Solutions segment, which represents a 16.5% increase as compared to the previous Q4. For the Civil segment, with a 4.9% revenue increase, its revenue reaches $811 million in Q4. The Health segment is the only one that has a decreased revenue. Its total revenue of $513 million decreased by 2.5% as compared with the prior Q4. The negative impacts caused by the pandemic were partially offset by the acquisition-related revenue or the systematic recovery.

Leidos provided the guidance for fiscal 2021, they expect revenue of $13.7 – 14.1 billion, adjusted EBITDA margin of 10.3 – 10.5%, Non-GAAP diluted EPS of $6.15 to $6.45, and the cash flow provided by operating activities at or above $850 million.

Mergers & Acquisitions Activities

On January 31, 2020, Leidos completed the acquisition of Dynetics, Inc., for about $1.65 billion cash. Dynetics is a company that focuses on applied research and national security. This acquisition enhanced Leidos’ competitiveness in defense, intelligence, and civil area.

On May 4, 2020, Leidos completed the acquisition of L3Harris Technologies Security Detection and Automation businesses, for about $1 billion cash. By having SD&A businesses, Leidos combined it with existing screening products under the Civil segment.

On January 14, 2021, Leidos completed the acquisition of 1901 Group for about $215 million cash. Leidos greatly improved the capability of providing IT, clouding, and cybersecurity services.

Besides, to attract maritime clients, Leidos has entered into the definitive agreement to acquire Gibbs & Cox, Inc. with $380 million cash. In expectation, this acquisition will
be closed in the second quarter of 2021.⁹

<table>
<thead>
<tr>
<th>Target Company</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dynetics, Inc.</td>
<td>$1.65 billion cash</td>
</tr>
<tr>
<td>L3Harris Technologies SD&amp;A</td>
<td>$1 billion cash</td>
</tr>
<tr>
<td>1901 Group</td>
<td>$215 million cash</td>
</tr>
<tr>
<td>Gibbs &amp; Cox, Inc.</td>
<td>$380 million cash</td>
</tr>
</tbody>
</table>

*Source: Leidos Holdings, Inc. Fiscal Year 2020 Results⁹*

The M&A activities played an important role when we were trying to estimate future performance. We learned that the reason why the company had relatively stable margins and revenues during the pandemic is that the net gains or revenues brought by past acquisition activities partially offset the negative impacts Leidos faces. Based on it, we will hold a positive attitude as these deals will bring new blood. However, as Leidos only announced that the acquisition of Gibbs & Cox, Inc. so far, and there is a rebound in the interest rate, we assumed that it will not hold new M&A activities in the projection period.

**Recent Contracts**

Leidos has won $21.7 billion contracts in 2020. The unit price ranges from $1 billion to $7.7 billion.³ The most notable ones are the $7.7 billion Next Generation Enterprise Network Service contract awarded by the Naval Information Warfare Systems Command, the $649 million Special Operations Command Tactical Airborne Multi-Sensor Platforms Support which is awarded by the Army Contracting Command, and the $304 million contracts awarded by the U.S. Intelligence Community.

**MARKETS AND COMPETITION**

**The Threat of New Entry**

The barriers to entry into the Defense Contractor industry are relatively high, which means that the threat of new entries is relatively lower than in other industries.

First, new suppliers know little about the contracting processes, they even do not know how to get the initial contract. Second, as we mentioned before, R&D expenses are critical within this industry. For Leidos, even though the company-funded R&D expenses only account for 0.6% of the total revenues in 2020, it is still a considerable $73 million expense. Small or emerging suppliers rarely have the ability to handle that. Third, it is difficult to build relationships with defense clients. There are people who argue that the defense budget should be focusing on broader integrated systems rather than smaller solutions. Fourth, government contractors need to comply with complex bidding processes and regulations. They are subject to the government’s audit. However, the contracts may be terminated by the government at any time. Lastly, the contract cycle is not certain.²⁰ In 2020, many defense contracts were adversely affected by the COVID-19 as the government has to change the priority so that the contracts were delayed. Thus, we believe the threat of new entry will not be high, and Leidos is able to achieve an overall 9.87% revenue growth this year.²

**Peer Comparisons**

Competitions for contracts are fierce as Leidos does not only compete with large-scale companies, but it also competes with small-scale but specializes in certain areas companies. The competitors we chose based on Leidos’ 10K and FactSet are Booz Allen Hamilton, Perspecta, CACI International, ManTech International, Science Applications International, and General Dynamics Corporation.

There are three major types of contracts that companies may win: Cost Reimbursement (CR), Firm-fixed-price (FFP), and Time & Materials (T&M).⁹ On average, the contracts have a base period of 5 years, but it may be followed by an option to extend for 2 or 3 more years.

- As shown in the chart, generally, more than half of the total contracts are Cost Reimbursement contracts. The proportion ranges from 23% to 68%. This type of contract covers both direct and indirect costs in addition to the contract profit. It is suitable when involving uncertainties that are hard to be priced at fixed costs. It carries the lowest risks for the company. And it requires the company to accomplish as much as possible within the time scope.¹
- The weight of Firm-fixed Price contracts ranges from 19 – 57%. These contracts have prices that are predetermined by the firm. If companies achieved the goal with lower costs, the profit would be higher. However, it also takes the risk of having higher than expected costs.¹
- Usually, the smallest segment is Time & Materials (12 – 22%). This type of contract offers a fixed hourly rate and direct cost coverage. It is common when the time scope or work scale is uncertain.¹
We are not surprised to find these companies primarily earn revenues domestically from the following chart. Comparing to others, GD does a good job at diversifying as it earned 18% revenue from foreign countries. On the contrary, PRSP & SAIC only focus on the US market, which may be a potential concern in the future.

Source: FactSet

Booz Allen Hamilton (BAH)

Booz Allen Hamilton is a leading company that provides management consulting services for both commercial, government, and military clients. Booz Allen Hamilton also developed businesses in analytics, digital solution, engineering, and cyber areas.21

BAH operates through Defense (48%), Civil (27%), Intelligence (22%), and Global Commercial (3%) segments as a prime contractor or a sub-contractor.1

Source: FactSet

Perspecta (PRSP)

Perspecta devotes itself to helping federal, state, and local governments with enterprise IT services and solutions. It categorizes consumers into Defense and Intelligence (69%), Civilian and Health Care two segments (31%).1

Source: FactSet

According to FactSet, 47.8% of Booz Allen Hamilton’s total revenue is the yield from the Defense Contractors industry. The $3569 million industry revenue earns it 2.89% market shares.4 Similar to Leidos, Booz Allen Hamilton generates 96.5% of total revenue within the U.S., the remaining part is generated from countries like China, Japan, Germany, India, etc..5

Source: 2020 Booz Allen Hamilton Holding 10K

Source: 2020 Perspecta, Inc. 10K

We learned from FactSet that Perspecta only competes within the U.S. Government IT Services industry, 100% of its total revenue was from it. With its $4504 million industry revenue, it earns a 27.04% revenue share.4,5
CACI International (CACI)

CACI focuses on helping the government to ensure national security by implementing modernization and transformation. It operates through Domestic Operations (97%) and International Operations (3%) two segments.¹

The Domestic Operations concentrates on transforming the way that governments do businesses, enhancing C4ISR & Cyber capabilities, and optimizing decisions.¹

The International Operations generates revenue through CACI Limited and CACI BV, which are the operating subsidiaries in Europe. CACI provides IT services, data and software products for foreign commercial and government clients.¹

Source: 2020 CACI International 10K

ManTech International (MANT)

ManTech starts the business with single contracts from the Navy. ManTech offers innovative and integrated IT services and solutions for government departments and agencies for over 50 years. By customer type, it categorizes the business into two segments: the U.S. Government, and State agencies, international and commercial entities. The Department of Defense and federal civilian agencies are the major consumers.¹

As indicated in the chart below, 98% of the total revenue is earned through contracts with the U.S. government, the remaining 2% is earned through State agencies, international and commercial entities. According to FactSet, ManTech competes completely in the Aerospace and Defense IT Services industry. It earns $2518 million in revenue within the industry, which represents 22.34% of the total market share.⁴ ManTech has a similar geographic revenue structure as other companies we mentioned earlier. It generates 99% of total revenue domestically, the other 1% was generated from countries like China, Japan, Germany, etc.⁵

Source: 2020 ManTech International 10K¹

Science Applications International (SAIC)

Science Applications is a leading company that provides enterprise, technical, and engineering services primarily for the government. It has built a stable relationship with the Army, Air Force, Navy, Department of Defense, and other government agencies like the National Aeronautics and Space Administration in the past 50 years. Key offerings include technology integration, transportation, and maintenance of ground and maritime systems.

Supporting by a strategy, growth and innovation organization, SAIC operates through three customer-facing segments, which focuses on customer relationships, development, management, and delivery & execution. We do not provide a revenue decomposition pie chart here as these three operating segments are aggregated into one reportable segment for financial reporting purposes.¹

The major clients consist of the U.S. Army (17%), the U.S. Navy (11%), the DoD (19%), and other federal government departments or agencies (51%).

Just like ManTech International, Science Applications also competes for 100% within the Aerospace and Defense IT
Differently, the $6379 revenue makes Science Applications the first position in this industry. It owns 56.59% of the total market share.

**General Dynamics (GD)**

As a leading aerospace and defense company, General Dynamics provides high-end products and services to consumers. The key clients are the Department of Defense, the Intelligence Community, Homeland Security, and Health and Human Services. It conducts businesses through four operating segments: Technologies (34%), Marine Systems (26%), Aerospace (21%), and Combat Systems (19%).

Referring to FactSet, it does not rely too much on revenues generated from the Defense Contractors industry, which only represents 12.54% of the total. With the $4756 million revenue generated from the industry, it only takes 3.85% of the total revenue share. However, it has a more diversified revenue based on geography. About 82.3% of the total revenue was generated domestically, 2.8% was from Canada, 1.3% was from Germany, etc.

### Balance Sheet

Also, as the percentage of sales, we assume both Receivables and current assets like prepaid expenses will remain the historical average level, which are 18.54% and 4.52%. Leidos did not provide the CapEx guidance, so we decided to follow FactSet’s consensus CapEx estimation. To estimate the net PP&E, we use the beginning net PP&E, plus the CapEx, then minus the depreciation expenses. By calculating the Operating leave ROU assets as the percentage of net PP&E, we got an historical average number of 117.78%. We used it to make estimations in the projection period.

### Dividend policy

We observed that the annual dividends per share was $1.28 from 2014 – 2018, it increased $0.04 in 2019 and 2020, which leads to a $1.36 annual DPS. Thus, we expect it to remain at $1.36 for the first 5 years, and then increase to $1.40 and remain there for the next 5 years.

### EPS

As indicated below, the Henry Fund has a more conservative projected EPS in the next three years as comparing to the consensus. Leidos had a 11.8% CAGR of total revenues in the most recent 5-year period and we believe it will continue to grow. However, we do not think it can retain such a high growth rate. Rather, we would like to see more moderate growth in the following years.

---

**Source:** 2020 General Dynamics Corporation 10K

**Source:** Henry Fund Model, FactSet
Discounted Cash Flow

To calculate the implied DCF price, we need to calculate WACC first. The Henry Fund team decided to use the current 20-year Treasury bond yield as the risk-free rate and the Henry Fund estimated 4.9% equity risk premium. Moreover, we choose to use 5-year weekly raw beta and the sum of the yield to maturity on Leidos’ 10-year corporate bond and the 10-year default spread as the pre-tax cost of debt.\textsuperscript{14} We calculated the cost of equity based on the CAPM formula. Then, we got the estimated WACC of 6.78%. We assume the CV growth of NOPLAT as 3%, which is slightly lower than the CV growth of EPS, our DCF model gives us the implied price of $128.40. As the DCF model takes operating assets, non-operating assets, debt, and other contingent investor claims all into consideration, it can provide us much more completed long-term information. It is a reliable way to calculate the implied share price for Leidos as it does not only consider the Income Statement data.

Dividend Discount Model

The key assumptions for DDM are 3.5% CV growth of EPS, 16.09% CV year ROE, and the 7.31% cost of equity we calculated before. By having these, we can calculate the P/E multiple for the CV year, then we time the multiple with CV year EPS, which gives us the future stock price. Lastly, we discounted DPS and the future stock price. DDM model returns a $126.43 implied price. On the contrary to the DCF model, DDM works well for the short-term period. It is simpler than the DCF model as it only refers to EPS on the Income Statement. This is exactly why we prefer DCF rather than DDM.

Relative Valuation

To accomplish the peer comparisons, we chose Booz Allen Hamilton, Perspecta, CACI International, ManTech International, Science Applications International, and General Dynamics as Leidos’ comparable companies. All these companies develop partial or major businesses within the Government Contractor sector, which means that we assume they tend to have similar performances. Shown below is our relative valuation model. The two ratios we selected are the P/E ratio and P/S ratio, and they yield $72.72 and 111.57 as our implied share price, respectively. Overall, we believe that our models return us a non-biased price range of $115-125.

KEYS TO MONITOR

Even though people have started to get vaccinated, it is still important and necessary to monitor the COVID-19. Though there was a 10% growth in total revenue,\textsuperscript{2} it does not mean that the company is not affected by the pandemic at all. In fact, these negatives were offset by some revenue generated by acquisition-related revenues.

According to Leidos’ 2020 10K, about 87% of the total revenue was from government contracts, either as a prime or sub-contractor.\textsuperscript{1} This is both a strength and a weakness for the company. Generally, we assume the relationship will last for a long period. However, the government will not guarantee the payment. It may be delayed due to the cut in budget or the change in priority. Leidos will be adversely affected in that way.

We believe there is a rebound in interest rates, which means that it is more costly to borrow than before. Under this situation, we should be more careful about holding M&A activities or issuing long-term debts.

REFERENCES

1. FactSet 10K
2. Model
3. Court ruling caps stellar 2020 of contract wins for Leidos
4. FactSet RBICS Rev
5. FactSet GeoRev
6. Gross Domestic Product, Fourth Quarter and Year 2020 (Second Estimate)
7. U.S. DEPARTMENT OF THE TREASURY
8. Unemployment Rate
9. Leidos Holdings, Inc. Reports Fourth Quarter and Fiscal Year 2020 Results
10. Leidos drops on Q4 earnings, provides 2021 guidance
11. Leidos Completes Acquisition of Dynetics, Expanding Company’s Portfolio with New Offerings and Technical Capabilities
12. Leidos Completes Acquisition of L3Harris Technologies’ Security Detection and Automation Businesses Creating a Comprehensive, Global Security and Detection Portfolio
13. Leidos completes acquisition of 1901 Group
14. Bloomberg
15. Leidos markets Defense
16. Congressional Democrats urge Biden to cut
17. **No Growth, No Big Cuts Likely For First Biden Defense Budget**

18. **Leidos Awarded Payment From VirnetX, Inc. Lawsuit Against Apple Inc.**

19. **Responsibility & Sustainability**

20. **Identifying and Eliminating Barriers Faced by Nontraditional Department of Defense Suppliers**

21. **NetAdvantage, CFRA Equity Research**

22. **Contracts with foreign governments or international organizations**

23. **Share of people who received at least one dose of COVID-19 vaccine**

24. **Data rights**

25. **Sustainalytics**

26. **NetAdvantage: CFRA Equity Research, CACI International Inc**

**DISCLAIMER**

Henry Fund reports are created by graduate students in the Applied Securities Management program at the University of Iowa’s Tippie College of Business. These reports provide potential employers and other interested parties an example of the analytical skills, investment knowledge, and communication abilities of our students. Henry Fund analysts are not registered investment advisors, brokers or licensed financial professionals. The investment opinion contained in this report does not represent an offer or solicitation to buy or sell any of the aforementioned securities. Unless otherwise noted, facts and figures included in this report are from publicly available sources. This report is not a complete compilation of data, and its accuracy is not guaranteed. From time to time, the University of Iowa, its faculty, staff, students, or the Henry Fund may hold an investment position in the companies mentioned in this report.