Morgan Stanley | RESEARCH

UPDATE

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Defense | North America

Middle East Implications: Initial Thoughts

We offer initial thoughts on the potential implications for Defense stocks following recent events in the Middle East. We continue to believe the sector currently offers value. OW-NOC remains our Defense Top Pick.

Iran over the weekend launched >300 drones and missiles towards Israel, in stated response to the targeting of an Iranian consulate in Syria on April 1st (link). We offer initial thoughts on implications for the defense sector below.

Expect Defense to trade higher. We expect Defense stocks to trade higher Monday. Defense Primes are now trading at a ~15% discount to the S&P 500 on a NTM P/E basis, roughly in-line with the median relative discount over the past ~5 years. The Prime group has traded ~flat YTD vs. the S&P 500 up ~7.5%, after underperforming the market by ~27% in 2023 (group down ~3% vs. market up ~24%). While Defense Primes have narrowed their relative discount to the market post-Russia's invasion of Ukraine (now ~15% vs. ~25% prior), we continue to see the pullback since 2023 as overdone. We note Defense traded at ~parity with the S&P in the ~9 months following the start of the Ukraine conflict. The market, in our view, may today be over-discounting the 'velocity' of geopolitics.

Aid package could be accelerated. We see this weekend's developments potentially accelerating a supplemental US military aid package to Israel. The current White House supplemental defense spending proposal (~$100bn) has been held up in Congress since first proposed in October 2023. We note the majority of funding under this ~$100bn proposal is earmarked for Ukraine, but the package also offers notable funding for Israel, Taiwan, and other priorities. Speaker of the House Mike Johnson suggested that an aid package could now be revisited this week (link). The administration had previously indicated ~60% of this funding would flow to the US industrial base, which – in its current form – reflects ~7% of the Defense Department budget. We note the precise legislative path to passage still remains unclear. A standalone ~$17.6bn aid bill for Israel failed to pass in the House in February (link).

US involvement may be limited for now. The Biden administration has reportedly indicated that it will not take part in any offensive counter-action against Iran (link), and is working alongside G7 allies to prevent wider regional escalation (link). That said, US systems intercepted >70 Iranian drones and three ballistic missiles, per US officials (link). At least three ballistic missiles were downed by the Aegis missile defense system (LMT is the prime contractor), which is featured on US guided-missile destroyers. RTX is the prime contractor for the Aegis system's interceptor family (Standard Missile).

Israel has a relatively robust domestic defense industry. Main players include

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DEFENSE

North America
Industry View **Attractive**

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Israel Aerospace Industries (IAI), Elbit (not covered) and Rafael. While we generally see a preference for indigenous procurements, Israel is also an importer of significant US defense systems. The country, for instance, has purchased 50 F-35s via FMF grants (~36 aircraft have delivered as of March 2023). Major recent announced procurements also include CH-53K Heavy Lift Helicopters (LMT) and KC-46A aerial refueling aircraft (BA).

The US provides dedicated funding for Israeli and joint US-Israeli missile defense programs. This funding is provided via annual appropriations, including for the Iron Dome, David's Sling and Arrow systems. RTX is partnered with Rafael for Iron Dome co-production, with RTX manufacturing Iron Dome's Tamir interceptors. RTX and Rafael also co-developed David's Sling, which leverages RTX's Stunner interceptors. BA collaborated with IAI on earlier versions of the Arrow missile defense system. LMT is also collaborating with Rafael on Iron Beam – a High Energy Laser missile defense system.

Northrop (NOC) remains our Top Pick in Defense. We continue to see NOC with the best-aligned portfolio to the most pressing Defense Department needs, including areas like nuclear modernization and Space. We view NOC as the Defense ballast to own in given its multi-year growth story, a credible margin expansion roadmap, and earnings visibility. PT $579.

Valuation Methodology and Risks

Northrop Grumman Corp. (NOC.N)

We arrive at our price target of $579 by placing a ~26x multiple on base case 2025E FCF/share of $22.20. We see the multiple (~30% premium to Defense peers) warranted given the scarcity value of NOC's portfolio position, earnings visibility, and growth outlook.

Risks to Upside

- Perceived or realized security threats increase
- Better execution extends margins
- New program wins drive revenue higher

Risks to Downside

- Perceived or realized security threats decrease
- Execution challenges of early stage development contracts impacts future wins
- New entrants from commercial players

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(as of March 31, 2024)

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Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category	Count	% of Total Other MISC
Overweight/Buy	1458	38%	319	44%	22%	639	40%
Equal-weight/Hold	1730	45%	328	46%	19%	722	45%
Not-Rated/Hold	2	0%	0	0%	0%	1	0%
Underweight/Sell	625	16%	70	10%	11%	232	15%
Total	3,815		717			1594	

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months. Due to rounding off of decimals, the percentages provided in the "% of total" column may not add up to exactly 100 percent.

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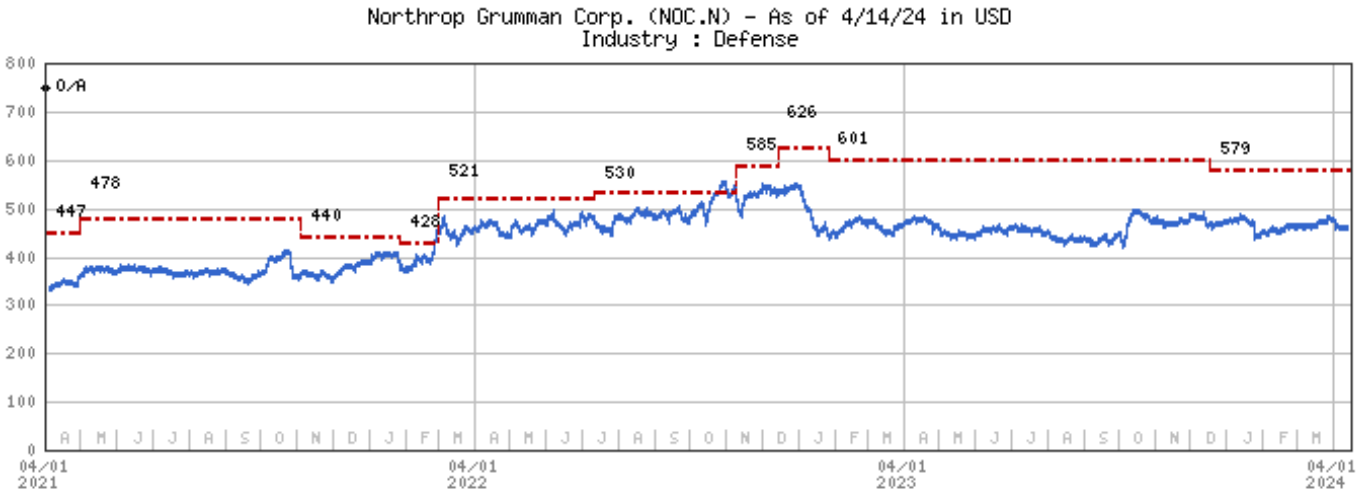
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Price Target History: 2/13/19 : 308; 6/14/19 : 335; 8/5/19 : 418; 10/9/19 : 437; 12/12/19 : 449; 3/24/20 : 380; 4/13/20 : 412; 4/30/20 : NA; 9/7/20 : 470; 1/6/21 : 453; 2/8/21 : 447; 4/30/21 : 478; 11/4/21 : 440; 1/27/22 : 428; 3/2/22 : 521; 7/12/22 : 530; 11/10/22 : 585; 12/15/22 : 626; 1/27/23 : 601; 12/18/23 : 579

Source: Morgan Stanley Research Date Format : MM/DD/YY Price Target No Price Target Assigned (NA)
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COMPANY (TICKER)	RATING (AS OF)	PRICE* (04/12/2024)
Kristine T Liwag		
General Dynamics Corp. (GD.N)	E (02/04/2022)	$287.87
L3Harris Technologies Inc (LHX.N)	O (12/15/2022)	$202.62
Lockheed Martin Corp (LMT.N)	E (12/15/2022)	$450.40
MDA Ltd (MDA.TO)	E (04/27/2021)	C$14.53
Northrop Grumman Corp. (NOC.N)	O (09/07/2020)	$456.11
Textron Inc. (TXT.N)	O (06/29/2021)	$93.96

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