The National Defense Authorization Act that recently passed the House of Representatives, and will presumably be passed by the U.S. Senate, is a milestone, a shift away from large platform costly appropriations and a turn towards new technologies, such as space-based warning systems, cyber warfare, smaller autonomous unmanned platforms, artificial intelligence, machine learning, hypersonics (flight at speeds above Mach 5) and directed energy. The new defense budget also includes $9.6 billion in appropriations for cyber warfare. Within all of the service allocations, military software is being given far more emphasis and funding.

There are only a handful of publicly traded companies involved in this business, including Science Applications International Corp. (SAIC), and CACI International, Inc. (CACI). In other words, the US Government is spending substantial amounts on various defense programs and the defense budget has increased, but the orientation is away from the large-platform expensive equipment and weapons. That is not necessarily bad for the defense industry, even for the largest defense contractors. They will just reorient their businesses. However, it will probably be very beneficial for companies such as SAIC and CACI, which focus on the so-called "C4I" —Command, Control, Communications, Computers and Intelligence. A cyclical aspect of their environment is that many of the programs these companies might work on were denied full funding during the prior two Washington administrations. The present one is increasing funding for defense.

A related consideration is relative scale: SAIC and CACI, despite their persistent growth for many years, are still in the $5 billion market value range, whereas the traditional defense firms like Lockheed Martin, Boeing, Raytheon, et al, are in the $35 to $100 billion class. The expansion of government demand for these types of services that will be required for data, communications and military security and warfare in the digital world can have a dramatically greater beneficial impact on the SAICs and CACIs.

SAIC provides technical, engineering and enterprise information technology (IT) services to the U.S. government. It focuses on priority areas such as IT modernization, cloud migration, managed services and DevSecOps. Most of the military and intelligence contracts that deal with software or command and control and matters of that type are extremely secret and are not even delineated on the defense budget as such. It is actually included in "other items", so it is very difficult to know much about these contracts. Very few companies have the security clearances required to compete for these projects, which means that there are generally very few bidders. The Department of Defense generally accounts for just over half of the revenues, with most of the remainder derived from other federal government agencies. Commercial, state and local governments account for approximately 2% of revenues[1].

CACI is very similar to SAIC, in terms of operations, revenues, profitability and market capitalization. It was founded in 1962. Its main areas of expertise include data integrity and information, command and control, cyber security, and intelligence and it does most of that for the U.S. government. Two-thirds of sales are from the Department of Defense, which includes the various Armed Forces and classified Department of Defense customers. Another quarter are from Federal Civilian customers such as the Departments of Homeland Security and Justice. The demand for its services is mostly created by the increasingly complex

[1] Source: Company reports

network, systems and information environment in which governments operate, and the need to stay current with emerging technology while increasing productivity.

CACI and SAIC are among a handful of companies in this sector, most clustered in the Virginia area near the Pentagon and often referred to as the "Beltway Bandits". Both have grown to their current sizes partly because of acquisitions of small competitors. SAIC completed the acquisition of Engility Holdings in early 2019. This was funded by approximately $1.5 billion in stock and $900 million of assumed debt. Engility itself acquired defense contractor TASC in a deal worth just over $1 billion in 2014, which is yet another example of the consolidation in the industry. More recently, in March 2020, SAIC closed its $1.2 billion acquisition of the federal contracting business of Unisys, a publicly traded IT company, in a bid to capitalize on the Defense Department's nascent effort to build cloud computing technology into its operations. CACI spent approximately $1.0 billion on its 2019 acquisitions of LGS Innovations and Mastodon Design. Another notable acquisition in the defense industry is the April 2018 $9.7 billion buyout by General Dynamics of CSRA Inc., itself a combination of former competitors Computer Sciences Corporation's North American public sector business and SRA International. CACI had made a competing offer to acquire CSRA but was outbid by General Dynamics. However, after this acquisition closed, CACI was able to purchase CSRA's Systems Engineering unit from General Dynamics.

SAIC trades at a P/E ratio of 11x, even though it is expected to expand earnings per share (EPS) by approximately 10% and 15%, respectively, in 2020 and 2021, based on Wall Street's consensus. CACI trades at 17x 2020 EPS and is expected to expand this 20% and 12%, respectively, in 2020 and 2021. It is, therefore, trading more or less in line with the large defense companies, even though the growth rates of CACI and SAIC are superior and despite that the programs with which these companies are associated will likely continue to be the faster-growing areas. Very few companies should be beneficiaries of that trend to the same extent as CACI and SAIC.

A characteristic of defense companies, generally, is that to the degree that they are cyclical, by reference to the government's spending patterns, it is a different cycle than the general business cycle. In the case of the C4I defense electronics firms, they have been in a secular expansion mode. For instance, during the last cyclical downturn, the financial crisis, S&P 500 Index ("S&P 500") revenues declined by 4.6% (2006-2009) while CACI's revenues rose by 59%. Similarly, the S&P 500 earnings declined 42% but CACI's increased by 8%.

Although some investors probably consider all Defense companies to be lumped together as far as index inclusion and 'share of money' interest, the C4I companies are really not part of that group of large-defense-platform manufacturers. The only such company in the S&P 500 is L3Harris Technologies, which has a $40 billion market capitalization, compared to the approximately $5 billion of CACI and SAIC. Even so, L3Harris Technologies is less than a 0.2% weighting in the index. Therefore, SAIC and CACI will not be significant parts of defense ETFs. For example, they are not included in the top-15 holdings of the iShares U.S. Aerospace & Defense ETF (ITA), which is the largest defense-related ETF, with approximately $5 billion in AUM. Rather, the ETFs and defense-related indexes focus on the traditional large-cap S&P 500 defense contractors like Raytheon, General Dynamics, Lockheed Martin and United Technologies.

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