Q3 2022 Earnings Call

Company Participants

- Joseph DeNardi, Investor Relations
- Nazzic Keene, Chief Executive Officer
- Prabu Natarajan, Chief Financial Officer

Other Participants

- Cai von Rumohr, Analyst
- Gavin Parsons, Analyst
- Louie DiPalma, Analyst
- Matt Akers, Analyst
- Seth Seifman, Analyst
- Sheila Kahyaoglu, Analyst
- Tobey Sommer, Analyst
- Unidentified Participant

Presentation

Operator

Hello, and welcome to the SAIC Fiscal Year 2022 Q3 Earnings Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. (Operator Instructions). Thank you.

At this time, I would like to turn the call over to Mr. Joseph DeNardi. Please go ahead, sir.

Joseph DeNardi {BIO 22467920 <GO>}

Good morning, and thank you for joining SAIC's third quarter fiscal year 2022 earnings call. My name is Joe DeNardi, Vice President of Investor Relations. And joining me today to discuss our business and financial results are Nazzic Keene, our Chief Executive Officer; and Prabu Natarajan, our Chief Financial Officer.

Today, we will discuss our results for the third quarter of fiscal year 2022 that ended October 29, 2021. Earlier this morning, we issued our earnings release, which can be found at investors.saic.com, where you will also find supplemental financial presentation slides to be utilized in conjunction with today's call and a copy of management's prepared remarks. These documents, in addition to our Form 10-Q to be filed later today, should be utilized in evaluating our results and outlook along with information provided on today's call.

Please note that we may make forward-looking statements on today's call that are subject to known and unknown risks and uncertainties that could cause actual results to differ materially from statements made on this call. I refer you to our SEC filings for a discussion of these risks, including the Risk Factors section of our Annual Report on Form 10-K and quarterly reports on Form 10-Q. In addition, the statements represent our views as of today, and subsequent events may cause our views to change. We may elect to update the forward-looking statements at some point in the future, but we specifically disclaim any obligation to do so.

In addition, we will discuss non-GAAP financial measures and other metrics, which we believe provide useful information for investors, and both our press release and supplemental financial presentation slides include reconciliations to the most comparable GAAP measures.

It is now my pleasure to introduce our CEO, Nazzic Keene.

Nazzic Keene {BIO 18292745 <GO>}

Thank you, Joe. Good morning, everyone, and thank you for joining us to discuss our financial results and updated outlook for our third quarter fiscal year 2022. Before we begin, I'd like to welcome Joe DeNardi to his first earnings call with SAIC on this side of the table. We're excited to have Joe on our team to continue building on our already strong investor relations outreach effort, as well as add expertise and leadership to our executive team.

Now, onto our Q3 results. I'm pleased to report our 4th consecutive quarter of positive organic revenue growth and another quarter of strong profitability. Due to continued strong operating performance, adjusted EBITDA margin was 9% and contributes to the increase in our full year margin outlook. Our year-to-date, strong results reflect a commitment to our customer's needs, success in creating value for our shareholders, and a dedication to the mission from our 26,000 employees during a still challenging time.

Despite recent challenges related to supply chain disruptions and a tight labor market, we remain confident in our ability to sustain organic growth into next year and increased free cash flow by approximately 10%. We know that driving both of these metrics creates shareholder value. Prabu will provide further detail on our increased guidance for this year and initial outlook for next year in his prepared remarks.

I would like to focus my comments this morning on two new initiatives, which create value and opportunity for our employees and our shareholders. The first is what we're calling The Future of Work and it is our approach to enabling flexibility for our workforce, while increasing productivity and financial returns. The second is a reorganization of our internal investment effort, which has led to the creation of our Innovation Factory Teams, designed to better align our targets of organic investments with customer need in the areas of AI, engineering and digital.

Let me first start with The Future of Work. One of our top priorities continues to be ensuring that we are able to attract and cultivate the best talent, while managing through pressures related to attrition and COVID. While we have more open positions than we would like, we're taking steps to proactively address this challenge in new and industry-leading ways. In late September, we announced enhancements to our employee benefits package including the optionality of a four-day workweek, the addition of back up child and elder care, the recognition of Juneteenth as a paid holiday, and increasing paid family leave, while holding employee healthcare premiums flat for the second year in a row.

Under our Future of Work initiatives, we are streamlining our facility footprint, while investing assertively in a new operating paradigm. This advances our vision to promote employee well-being and our ability to attract diverse talent, while driving financial benefits in the form of increased competitiveness and cost savings. While this program will be implemented over a multi-year period, it is already underway and we have line of sight into annual cost savings of at least $25 million, which we expect to reinvest back into our workforce and to drive incremental growth into the future.

We continue to monitor COVID-19 vaccine mandates, and the impact they may have on our workforce and business operations over the next few months. To this point, we have not seen any noticeable impact on attrition or sourcing talent as a result of the vaccine mandate, and it is not materially impacting our financial performance. Our outlook for this year and next year assumes that this remains the case.

As of last week, roughly 96% of our workforce is compliant with our vaccine policy, and we would expect that to increase modestly going forward. For those in our workforce who are not vaccinated, we believe we can accommodate or reposition a large portion of these employees such that the eventual net impact is immaterial.

Now I'd like to spend a few minutes discussing the development of our Innovation Factory Teams or IFTs, and the initial returns we're seeing from our investments. A little over 2 years ago, we began the process of shifting our internal investments away from primarily enhancing program-specific capabilities to developing enterprise solutions directly aligned with future customer demand.

To aggressively drive this part of our strategy, this year we implemented changes to our organizational structure and incentive metrics to tighten collaboration between our Innovation Factory Teams and the growth priorities of our sectors. We are confident this refinement of our internal investment strategy will allow us to more efficiently and effectively invest shareholder capital. This focus and discipline will ensure our investments are well aligned with customer requirements and enhance our ability to market, sell and ultimately deliver differentiated solutions in growth areas like IT-as-a-service, application modernization and cloud management and systems integration.

A good example of this is the MK 48 program win announced just after the close of the quarter. The US Naval Sea Systems Command awarded SAIC a contract with a total value of up to $1.1 billion to integrate various subsystems for the MK 48 Mod 7 heavyweight torpedo. This win is a direct reflection of SAIC's unique understanding of the undersea domain coupled with our internal enterprise-wide investments in our digital manufacturing solution, our integrated logistics and supply chain solution, and other digital engineering solutions and capabilities.

This award significantly expands our scope on this program and highlights our ability to leverage our legacy as a leading provider of high-end engineering services and move opportunistically, and profitably into select systems integration and delivery roles. We currently have a rich pipeline of systems integration opportunities across multiple domains and customers.

To be clear, we remain prudent and disciplined to ensure that opportunities we pursue are ones where we know the technology, we understand the mission and domain, have understanding of the legacy systems, and where we are able to contract, partner and leverage organic investments in support of our long-term profitable growth strategy. We're excited about the new business pipeline in front of us and feel confident that our legacy and recent investments position us to drive profitable organic growth.

I'll now turn the call over to Prabu to discuss our financial results and updated outlook.

Prabu Natarajan {BIO 17701667 <GO>}

Thank you, Nazzic. We are pleased with our financial performance in the third quarter. We generated 2.1% of year-over-year organic growth, which represents our 4th consecutive quarter of positive growth. Our third quarter revenues of approximately $1.9 billion reflect total growth of 4.4%, as compared to the third quarter of last fiscal year, due to the ramp up on new and existing contracts and the addition of Halfaker.

Revenue results in the quarter were impacted by lower than planned materials sales, labor market tightness and a slower ramp in our supply chain business. Adjusted EBITDA dollars and margins were both ahead of plan due to continued strong execution and effective cost controls. Third quarter adjusted EBITDA was $171 million, a $7 million increase from the prior year. Adjusted EBITDA margin was 9% after adjusting for $12 million of acquisition and integration costs. Diluted earnings per share was $1.22 for the quarter, inclusive of the third quarter acquisition and integration costs of $12 million. Excluding these costs, as well as amortization of intangibles and net of a lower effective tax rate of approximately 19% in the quarter, our adjusted diluted earnings per share was $1.85, an increase of 14% compared to last year.

Third quarter free cash flow was $124 million and free cash flow year-to-date continues to track ahead of plan. I would note that the year-over-year decline in third quarter free cash flow is due to the timing of payroll tax payments related to the CARES Act, as underlying working capital efficiency continues to improve. In fact, adjusted for the impact of the payroll taxes deferral, operating cash flow has grown nearly 7% and free cash flow has grown about 9% year-to-date.

During the third quarter, we deployed $97 million of capital, including $63 million of share repurchases, $21 million of dividends and $3 million for acquisitions. In addition, we continued to delever, making mandatory debt repayments and ending the quarter with a net leverage ratio of roughly 3.5 times. We continued to prioritize share repurchases over voluntary debt repayment in the quarter.

Net bookings in the quarter were $1.4 billion for a book-to-bill of 0.7 and results in a trailing 12 month book-to-bill of 1.1. It is important to note that the MK 48 award slipped out of the third quarter and was booked subsequent to the close of the quarter. Our third quarter book-to-bill would have been about 1.2, with a trailing 12 month (Technical Difficulty) MK 48 had booked in the quarter.

Based on results to-date, we are increasing guidance for revenue, EBITDA margin, earnings per share and free cash flow. We are increasing revenue guidance to $7.35 billion to $7.4 billion, with a bias towards the higher end of the range. This implies roughly 1% to 2% organic growth in our fourth quarter, reflecting modest, incremental pressure related to the timing of materials sales and a challenging market for attracting talent.

We are increasing our guidance for adjusted EBITDA margins by 10 basis points to 9% to 9.1% to reflect strong performance across the portfolio. We are increasing adjusted earnings per share guidance by $0.25 to a range of $6.75 to $6.95. Finally, we are increasing free cash flow guidance by $20 million at the low end to a range of $450 million to $470 million.

I would now like to provide some directional guidance for SAIC's fiscal year 2023. We expect to generate positive organic revenue growth in FY23 and have the pipeline and business development opportunities to sustain this beyond FY23. We will be in a position to provide more detail on the key drivers and assumptions (Technical Difficulty) '22. However, we believe this outlook, while not without risk, properly captures the opportunities in front of us while balancing (Technical Difficulty) certain potential contract transitions.

Further, we believe we can deliver positive organic growth in FY23 even without a full recovery in our supply chain business. For context, we expect our logistics and supply chain business to generate just over $600 million in revenue in FY22, down from well over $700 million in the years prior to COVID. We do expect this business to improve over time and are hopeful of an inflection in the near future. However, our ability (Technical Difficulty) business.

We remain focused on improving margins in this business (Technical Difficulty) automation and differentiated bid strategies that can add value to our overall portfolio. (Technical Difficulty) EBITDA margins in FY23 to be in the high 8% range in line with a normalized margin rate for our business as previously communicated. I would note that there is opportunity to improve margins over time, as we continue our journey to transform the business.

Lastly, we expect to generate free cash flow growth in FY23 of approximately 10% from the mid-point of our updated FY22 cash guidance. We see opportunities to structurally improve the cash conversion of our business over the next few years and have a roadmap of initiatives we are executing. As a result of these initiatives, we view our expected FY23 free cash flow as a base off which we can continue to grow in FY24 at a similar 10% rate. Our plan assumes we improve to become a top tier generator of free cash flow, and you'll recall that this is an important component of our incentive compensation plans.

We do not face any meaningful headwinds related to the roll-off of cash tax assets until FY26, which we expect to be manageable. Our view on cash assumes that the section 174 R&D headwinds are addressed via the bills pending before the Congress.

Finally, I would note that our priorities from a capital deployment standpoint have not changed, position and grow our portfolio to maximize shareholder value, return cash to our owners, and delever our balance sheet over time.

I'll turn the call back to Nazzic for some closing remarks.

Nazzic Keene {BIO 18292745 <GO>}

Thank you, Prabu. I'm pleased with the performance of our business this year and very proud of the SAIC team as we continue to deliver with excellence to our customers, to our shareholders and in support of each other.

As I look to the future, I'm optimistic about our ability to convert a robust set of opportunities over the next few quarters into shareholder value. The investments we have made internally, combined with our deep technical expertise, and most importantly, our tremendously talented workforce position us well to succeed. Before I turn the call over to the operator for our Q&A, I would like to wish everybody a wonderful holiday season.

Operator, over to you.

Questions And Answers

Operator

(Operator Instructions) Your first question comes from the line of Matt Akers with Wells Fargo.

Q - Matt Akers {BIO 22271349 <GO>}

Yeah. Hey, good morning, guys. Thanks for the question. I want to ask about the margin into next year and sort of the sequential drop off versus what will be done in kind of year-to-date. What are the kind of the biggest drivers of that? And I kind of want to thought maybe mix is still pretty decent for you guys. But just how you think about sort of getting that at the lower level?

A - Prabu Natarajan {BIO 17701667 <GO>}

Sure. Good morning, Matt. Prabu Natarajan here. Thanks for the question. With respect to this year, I'm going to answer this in two parts. Q4, what's implied in the guidance implies a step down in margin rates. I think there are a couple of drivers here. Year-to-date, I think our performance on margin has been really, really good. So we're very proud of the performance year-to-date.

In Q4, we are expecting to make additional investments in our innovation factories, as well as some other indirect expenses that have been under running year-to-date. So that sort of implies a margin compression in Q4, relative to the first three quarters. Clearly, it's an important metric for us and we're going to continue to do better than what's implied in the guidance. But that's sort of the Q4 compared to Q3.

With respect to FY23, consistently this year, we've described this business as being sort of in that high 8% margin rate. And sort of our prepared remarks, we were communicating that margin rates are in that range. So I'd say fairly in line with where FY22 margins would have been, but for a couple of one-time items that we had. So this year, we've called out over the course of the year about 70 basis points of one-time items that have benefited margin rates on a year-to-date basis.

I think there are a couple of contract transitions that could produce some modest level of margin pressure next year. I'd say, a couple of other factors to think about is, there are a few macro variables, which presents some uncertainty right now. I'd say, the labor market and operating perhaps Q1 in SCR, will sort of put us in a range, I'd say, at the high 8% right now.

But I'd reinforce the comment that sort of an early view of FY23, we will have an opportunity to talk about margin rate guidance for next year. And I would remind you that because we're focused on improving margins in the business via profitable growth, it's an important incentive compensation metrics. So it's an early view consistent with what we've communicated. And hopefully, we will have a chance to do better as we roll into FY23.

Q - Matt Akers {BIO 22271349 <GO>}

Okay. Got it. That's really helpful. And I guess there's one more kind of like capital deployment. I think you have talked about 3 times being kind of the leverage target for next year, but it sounds like you're kind of prioritizing share repurchases over paying down the debt is that, is this still the target? And kind of how important is that? Could you say a sort of a higher level buyback of stock with the traction here?

A - Prabu Natarajan {BIO 17701667 <GO>}

Sure, Matt. So we did end the quarter at about 3.5 times. We also ended the quarter with about 3 million shares remaining on our repurchase authorization. Our strategy really has not fundamentally changed our own capital deployment, really deploy capital to ways that generates the greatest long-term return for our shareholders. I think we have mentioned over the course of the year that if we find dislocations in stock price, we are going to take advantage of it. So view our Q3 performance as one where we saw some dislocation in value and we took advantage of it in the course of the quarter.

I'd say the capital deployment and creating value over time, those are essential components of how we think about the trades on a year-over-year basis. So I'd say, it's an important lever that is out there for us. With respect to the leverage ratio itself, we signaled, we would like to step down to about 3 times where we are sitting right now is organically there is a path for us to grow earnings and improve our cash performance. So organically, we do see ourselves getting to about 3 times. So I'd say, no real change from what we've previously communicated.

Q - Matt Akers {BIO 22271349 <GO>}

Okay. Great. Thank you.

A - Prabu Natarajan {BIO 17701667 <GO>}

Sure.

Operator

Your next question comes from the line of Seth Seifman with JPMorgan.

Q - Seth Seifman {BIO 16417112 <GO>}

Hey. Thanks very much, and good morning.

A - Nazzic Keene {BIO 18292745 <GO>}

Good morning.

Q - Seth Seifman {BIO 16417112 <GO>}

I know you mentioned, you give us more color on the March call. But just as we think, maybe just qualitatively about the different puts and takes to be aware of for top line growth in fiscal '23. I guess, maybe if you could run through a couple of those, what are the opportunities that are going to drive growth? How do you think about book-to-bill in the quarter that's going to end in January? And then what are kind of the headwinds? And how does hiring -- pace of hiring play a role in all that?

A - Nazzic Keene {BIO 18292745 <GO>}

Hi. This is Nazzic. A couple of comments. So thanks for the question. As Prabu indicated, as we look at next year, we do see the opportunity for continued organic growth and very pleased with our ability to do that. As we think about the programs that are coming online, we see some growth and we continued Army program that we won a couple of years or years ago, S3I. We see the ramp and some of our space related programs. And I'm looking at my notes here, sorry. What was the other one?

A - Prabu Natarajan {BIO 17701667 <GO>}

Risk.

A - Nazzic Keene {BIO 18292745 <GO>}

Risk. Sorry. Thanks, Prabu. And so we see those as ramping up as well as other very high probability pipeline opportunities. The biggest headwinds we see in the next year is the -- obviously the NASA program that's been discussed, as well as the potential headwind of the Vanguard program. And so as we balance those out and risk adjust that we still see the opportunity for profitable growth into next year, as Prabu indicated.

A - Prabu Natarajan {BIO 17701667 <GO>}

So a couple other data points here. So our focus has remained positioning the portfolio to enable us to grow the business profitably. We believe we can sustain organic growth into next year. And importantly, we have the pipeline to support the growth. There are scenarios where we are able to grow at rates faster than the rates at which we've grown over the last few quarters, but they will require us to win new work.

Nazzic is exactly right. I think S3I, we do see the ramp, we do see ramp in one part of the restricted space portfolio, as well as our Army RITS. And of course, we called up headwinds potentially from the NASA program. So as we sort of think about the puts and takes and given the number of new business pursuits that are out there waiting to be dispositions by early next year, we do believe we have an opportunity to do better on organic growth. So I'd say that's probably the organic growth comment.

With respect to book-to-bill at Q4, Mark 48 booked at the start of Q4, we expected that it would come in towards the end of Q3. We also have another space award that we were expecting to have in Q3 is likely also slipping into Q4. So as I think about book-to-bill, we don't ever want to provide guidance on a quarterly basis on book-to-bill. But I think, we're off to a healthy start is probably the way to characterize Q4. And candidly, we were expecting Mark 48 to book in Q3 and had that come through our book-to-bill for the quarter would have been about 1.2. And so I think I'd sort of give -- provide that as sort of additional context for the question. And hopefully that's helpful.

Q - Seth Seifman {BIO 16417112 <GO>}

Yeah. No, that's great. Thanks very much. And maybe just to follow up real quick on this theme of organic growth. You mentioned the hiring environment being difficult and you talked about some of the changes you're making to attract people. But I guess, if you can put a little bit more color on sort of maybe the ways in which things are difficult or the degree to which the pace of hiring will be enable or be a break on growth going into next year?

A - Nazzic Keene {BIO 18292745 <GO>}

Yeah, let me provide a little bit of color and then certainly Prabu can weigh in. As I think consistent across many industries, ours included, is there is a tightening labor market. And we're certainly seeing that as well as it relates to COVID, as it relates to some just the general turnover. I think, the way that we're thinking about it is to ensure that we are doing things disproportionately creates an attractive workforce for ourselves. So that we mitigate attrition. So we look to internal efforts to drive engagement, flexibility is key, we've learned that certainly from the COVID experience and employees are looking for that. So we're doing a great deal around ensuring that our employees can continue the flexible work model. Obviously, hand in glove with the customers.

So we've got several initiatives taking place inside the company. I touched on some of the changes and benefits as well, to ensure that we remain in a very attractive place for our current employees, as well as be able to attract new employees. We've also done considerable work in ramping up our recruiting and our on-boarding process as well. And so we've seen great results over the course of the last couple of months in being able to attract and hire very qualified, great talent. So certainly a headwind, certainly something we're navigating. But I believe we are in a great position to be able to mitigate some of that risk going into next year, all things being equal, obviously.

As it relates to any other potential headwind on labor escalation or cost of labor, certainly, we're managing that as well. But the overall costs, we are not seeing anything significant at this juncture, because even though there is pockets where the cost of labor may rise or (inaudible) is going up. The other costs such as and you heard us talk about whether it's facilities, travel are also looking to be able to mitigate some of that. So we certainly were paying a lot of attention to it. It's top of mind. It's a key part of our strategy and our growth strategy, that we believe we're well positioned going into next year.

Q - Seth Seifman {BIO 16417112 <GO>}

Great. Thank you very much.

Operator

Your next question comes from the line of Noah Poponak with Goldman Sachs.

Q - Gavin Parsons {BIO 18748617 <GO>}

Hey. Good morning, guys. This is Gavin. I think that might have been an autofill. How you are doing?

A - Prabu Natarajan {BIO 17701667 <GO>}

Hi, Gavin.

Q - Gavin Parsons {BIO 18748617 <GO>}

Prabu, I got a bit of a two parter for you. On the organic growth rate for next year, I think without maybe reading too much into your remarks, you said there is a possibility or the opportunity to grow faster next year than you are this year if you win some work. So your base case assumption that you grow in line to slower than you are this year. And then as the follow-up to that, when you look back at how you approached original guidance this year, you've raised throughout the year. So kind of what was better than planned? And then there is that the same level of conservatism you want to take going forward or do you have more visibility now than you did coming in?

A - Prabu Natarajan {BIO 17701667 <GO>}

Sure. Hey, Gavin. Thank you for the questions. I'm going to take the second one first. So when we started out the conversation at the start of the year, we said, organic revenue guide of $7.1 billion to $7.3 billion [ph]. And then in the -- and towards the end of the first quarter, starting second quarter, we added Halfaker, which increased the top end of the revenue guide to about $7.4. If you look back and you look at where the top end of the current revenue guide is, it's still $7.4 reflecting the addition of Halfaker into the portfolio.

We said one of the guiding principles for us at the start of the year when we set guidance was how do we derisk the year as we go through the course of this. And so the consecutive revenue changes, guidance changes at the bottom end for each of the first three quarters reflects our team's fantastic performance derisking over the course of the year. So I'd say philosophically, we are thinking about the business as a way to start year and then derisk over the course of the year. So philosophically, I don't think we're going to see a whole lot different next year.

I did talk about potentially a robust pipeline of opportunities ahead of us. This is the first part of the question. And specifically the question around, could we grow at rates higher than potentially we are at for FY22? The answer is, there are a couple of big swingers' on the new business front, which could position us to grow a little bit faster than what's implied in the current year guidance with one important health warning, which is NASA NICS portfolio is in contract rather, it's in the portfolio this year, and we could have potential headwinds depending on how the protest gets dispositioned, as well as the timing of the protest itself.

So I'd say a good solid pipeline on the new business front was an opportunity to grow at rates, perhaps better than where we're at. But with the health warning that the outcome on NASA NICS could then have a little bit of a headwind effect to growth rates, which is why we're comfortable given how much of the year we have left to go and how much we have in the way of new business, starting out the year committing to continued organic growth in the portfolio that we believe an important signal to send to our shareholders to show that we are committed to growing this business on an organic basis year-over-year, and that's the focus of the team right now. And obviously, we'll share a lot more detail with you in March.

Q - Gavin Parsons {BIO 18748617 <GO>}

Got it. That's really helpful. Do you have good visibility into the timing of some of those new wins? And does that potentially impacted by an extended continued resolution?

A - Prabu Natarajan {BIO 17701667 <GO>}

So the answer is, to the first part is yes. And I think the answer to the second part is also, yes. I would say that next 2 months to 5 months will be fairly indicative of where FY23 will shake out. And our hope is, it's earlier in that window rather than later. But we'll certainly have more visibility into FY23, by the time we get to March and provide our guidance for FY23.

Q - Gavin Parsons {BIO 18748617 <GO>}

Okay. Thank you.

Operator

The next question comes from the line of Cai von Rumohr with Cowen.

Q - Cai von Rumohr {BIO 1504358 <GO>}

Yes. Thank you very much. So Prabu, could you give us maybe the numbers on bids awaiting decision? And you talked of the big swingers, maybe give us some color if you could on your expected bids submits for Q4 or the next 6 months, whether -- whichever way you think is more meaningful?

A - Prabu Natarajan {BIO 17701667 <GO>}

Sure. I'll take the first part, Cai. So the bids awaiting disposition is about $21.5 billion. At Q2, that number was about $20 billion. So let's call it, we're up high single digits relative to the Q2 watermark. So I see the right directionally the better we want to see in terms of the outcomes. And in terms of the materiality of what's out there, for obviously a variety of strategic and competitive reasons, we would not talk specifically about any of those other than to say, they are needle moving opportunities for the company. So with some potentials upsized impacts on growth rates, but we have to go win them. And these are takeaways and so that's not obviously an easy combination. But we are well positioned for these opportunities, or we have to actually go win some of them, but they are needle moving for the company.

A - Nazzic Keene {BIO 18292745 <GO>}

And Cai, this is Nazzic. Just to add to that, Prabu gave you a couple of metrics. But anecdotally, we also see continued growth in the pipeline, consistent with the areas of focus and strategy for the company. So very pleased with the pipeline development. We've also done a lot of work this year in not just increasing the reach of our sales team and business development team, but also and ensuring that we're focused in the right accounts on the right solution. So very pleased with the development of the pipeline, consistent with our strategy, consistent with driving greater profitability over the years to come. And so we feel like we're in a good position. As Prabu indicated, we've got good visibility. But we also pay a lot of attention to the long-term health of the pipeline as well, I wanted to reinforce that.

Q - Cai von Rumohr {BIO 1504358 <GO>}

So I don't expect you to give us, the specifics on the potential takeaways. But maybe if you could give us some bounding of the size, I mean, what do you expect to submit in Q4 or next year? And secondly, you've mentioned a couple of times you know incentive comp depends on margin, depends on cash flow. Maybe give us, you know the things you are emphasizing with the incentive comp plan? And any changes in direction you might sort of be envisioning for the incentive comp plan? Thanks.

A - Prabu Natarajan {BIO 17701667 <GO>}

Sure. Thank you for the questions, Cai. So on incentive comp, at the start of FY'22, we made a set of really important changes. I think we balanced the metrics between revenue, adjusted EBITDA growth, as well as operating cash flow. And we balanced it by having the way to be a third, a third, a third across to three metrics. And we then set targets based off of relative peer performance. In other words, paying the team for performance against a plan is interesting. What's far more interesting is paying the team for performance against a relative peers set.

So we really made that really important change at the start of this year. And I believe we're starting to see some real traction from the changes we made. We also introduced an element of total shareholder return in the long-term performance metrics, especially to ensure that we are always committed to returning value back to our shareholders. So to me, I think those were really important changes we made at the start of the year. And I dare say, the performance this year reflects, I believe, the team's sort of embracement if you will, of that updated incentive comp metrics.

So that's sort of the first leg of the question. On sort of Q4 and book-to-bill, et-cetera, we really wouldn't get into the quarterly level book-to-bill guidance other than to say, while it's an important metric, it could also be misleading in some ways, because it can be very lumpy. It's a non-GAAP metric. And we define it perhaps a little bit differently than our peers, who might define it differently from their other peers.

So because of the variability, we'd rather not get into guidance around book-to-bill, other than to say, our backlog has remained at about $24 billion at the end of Q3. And we are committed to growing the total backlog as well as the funded backlog. And importantly, it is not an incentive comp metrics to go backlogs, but it does reflect the quality of the pipeline that Nazzic referred to, but also effectively not just growth rates, but also the margin rates implied in the pipeline. So there are some qualitative elements that we always look to, when we think about the backlog. And as Nazzic said, the team is doing a really nice job out there. And we're seeing some quality and some longevity in the backlog as well, that I believe is helpful for the long-term.

A - Nazzic Keene {BIO 18292745 <GO>}

And Cai, this is Nazzic. A couple of things, I'd like to add. I think Prabu captured exceptionally well. The other major thing that we did this year is actually, as we outlined the components of the incentive comp, we actually pushed it lower in the organization. And so, we can have many more leaders that are directly aligned to the same metric, same values that drive shareholder value. So I thought that was a very important move this year.

We are contemplating any significant changes to the plan. We believe it's balanced. We believe it's producing the right results. But we always take the opportunity to take a fresh look at that during our normal board cycle going into next year. But nothing specific is on the table. But if we step back and we say that, something would serve us better and serve the shareholders better, we do keep that top of mind as we go through the process.

Q - Cai von Rumohr {BIO 1504358 <GO>}

Thank you very much.

A - Prabu Natarajan {BIO 17701667 <GO>}

Sure.

Operator

Your next question comes from the line of David Strauss with Barclays.

Q - Unidentified Participant

Good morning, Nazzic and Prabu. It's Colin on for David. First question, if you could talk about working capital upside embedded in your guidance for free cash flow, as well as kind of what you envision for longer term potential capital efficiency for this business?

A - Prabu Natarajan {BIO 17701667 <GO>}

Sure. Thank you for the question, Colin. So as I think we've mentioned over the course of the year, we're a strong generator of cash. But we've also said over the course of the year, we believe there is real opportunity to improve the cash performance of the business. Over the last couple of quarters, we've spent a fair amount of calories inside the company to look at working capital performance specifically. And as Nazzic just alluded to, we're looking at working capital, not just at the consolidated level, we look at it at the sector level and then within a business unit level and within a program level.

And then we truly want to understand what drives working capital at the program level. There are a couple of opportunities here, the reason we're signaling potentially up to 10% increase in free cash flow next year is, if you think about the contract mix we have in a predominantly cost plus business and a T&M business, it is sort of our contractual right to be paid net 30, more or less. And so we see real opportunity on improving working capital there.

But we also see, you know if you think about the process for working capital, all the time that it takes to get costs accrue, get it on an invoice through a review cycle for the invoice all the way to the collection cycle, we see opportunity for an end-to-end improvement of our cash performance across the cash cycle. In addition to that, we also have significant number of subs, subs on our programs. And we want to make sure that we are looking at working capital at the sub-level to make sure that we have terms that are symmetric with the terms we have at the prime level, so we've slowed down terms appropriately and there's potentially opportunity there as well. So as we step back and look at fundamentally working capital improvement, obviously, it starts with profit improvement. And that's going to be a key for sort of persistent improvement to cash flow potential. But as we sit here, we see improvement potential in working capital and that's why we signaled in the prepared remarks that it's up to 10% improvement in free cash flow next year. And we see that FY23 free cash flow as offering a base off of which we can grow an extra 10% beyond that.

And then finally, as we mentioned in the prepared remarks, we do have some tax assets that we're currently benefiting from on a cash tax basis. But you don't really see a material step down until maybe FY26 or later. And the reality is, we expect those impacts to be quite manageable over the long-term. So I'd say, as we step back and look at the business, we see some real opportunity. And the fact that it's an important incentive comp metric, both in the near-term metrics as well as the longer-term operating cash metrics. We see some real opportunity and the team really committing to improving this at the enterprise level. And we've got an enterprise level initiative that Nazzic and I are chairing. And we're committed to truly making a difference over the next few years, because there is real value here.

Q - Unidentified Participant

Got it. And in terms of the guide rails for that metrics, should we be thinking about this as a percentage of sales, net working capital base kind of where do we think about or where do we hang our head on it's underlying working capital efficiencies?

A - Prabu Natarajan {BIO 17701667 <GO>}

Yeah. So if you think about, we've talked about DSO. And if you think about where DSO is currently, we're at about 60 days. And DSO is one component of the total working capital picture, but it's an important component. Every day of DSO is worth between $20 million and $25 million of cash. So if you think about a 10% improvement, that's implying about a two-day to three-day improvement in DSO over a period of time. And there is of course DPO, which is the payable side of this that we're highly focused on as well.

And so there is obviously structurally speaking, contractual terms that we're ensuring we get into contracts that we're getting into the books right now that allow us to liquidate if you will based on milestones we achieve on program milestone. So it sort of, there is a multi-pronged effort to it. But if you think about DSO as the most obvious one, we see two-day or three-day improvement at the low end and potentially provide some element of replicability over the years that allows us to get through far lower DSO days.

Q - Unidentified Participant

Got it. And then last one for me. But as we think about your go-to-market strategy between IT modernization and systems integration. Can you just talk about to the extent you're competing on price versus capability and how that's going to the margin guidance for FY23?

A - Nazzic Keene {BIO 18292745 <GO>}

Yeah. So I can certainly talk about the go-to-market. As we've indicated, the broad IT modernization, the cloud migration. all of those IT related programs, the good news is we do considerable amount of that today. And it is a significant part of our pipeline going forward, leveraging our partners, leveraging our own IP and leveraging very strong past performance. So we're well positioned in that broad market. We see it across all the customers we serve, whether it's the intel community, whether it's the DOD, whether it's the civilian agencies. And so very pleased with the maturation of that part of the pipeline. And certainly, see long-term opportunity to do that in general and there's always exceptions. But in general, that type of work tends to drive higher margins. The closer you get to an as a service model, the closer you get to being able to leverage our solutions and our IP, that does tend to drive higher margins, which is one of the reasons that we're optimistic about the long-term margin profile of the company.

A - Prabu Natarajan {BIO 17701667 <GO>}

And then on the quantitative side, as we think about the quality of the pipeline, one of the metrics we use to measure health and quality is whether there is an implied improvement to the margin rate organically at the company level, that's an important metric. And we have thresholds in place that allow us to put some extra eyes on bids that go below threshold rates if you will, to make sure that we're thinking about the bids on a consistent long-term basis. So to me, that's an important metric we track to. And we are likely to see continued improvement there. As we've said on the margin story over time, because we believe we have potential to improve there.

Q - Unidentified Participant

Thanks so much for the color.

A - Prabu Natarajan {BIO 17701667 <GO>}

Sure. Thank you.

A - Nazzic Keene {BIO 18292745 <GO>}

Thanks, Colin.

Operator

Your next question comes from the line of Tobey Sommer with Truist Securities.

Q - Tobey Sommer {BIO 6296228 <GO>}

Thanks. Good morning. We're hearing from many companies as they react to a tightening labor market. To the extent you've been able to benchmark your new labor initiatives to know where you're positioned better than the market. Have you been able to do that as opposed to sort of reacting to the tighter labor market and putting some things in place? So where do you stand out in that regard you think?

A - Nazzic Keene {BIO 18292745 <GO>}

Yeah, Tobey, this is Nazzic. Let me try to tackle that. I don't have any specific benchmarks in front of me. Many of the things that we touched on, as an example, to change and benefits we just implemented or messaged in September. So it's still early days. I will tell you that we are seeing you know we do our own internal metrics obviously on recruiting and offers, and we're seeing continued improvement in that regard in a pretty material way. So we feel good about the focus areas. We feel good about the investments that we're making. And I think we're well positioned going into next year.

Now with all that being said, there certainly it's broad industry market as it relates to turnover. And we're holding our own, as it relates to the labor pool, the turnover within the industry. And I don't see anything on either side of that, that is out of skew. So it is something that is top of mind. We actually have a --

We have a executive leadership team, get metrics every week, we're paying considerable attention to it. And we're doing several things internally to really expedite the ability to make an offer and onboard as just tightening that process up. So certainly, it's something we could probably add some color to as we go into the March timeframe and get a couple of cycles behind us. But I don't have any specific metrics. Prabu?

A - Prabu Natarajan {BIO 17701667 <GO>}

So just a couple of other quantitative data points, so as you step back and think about attrition rates, as well as required headcount. Last year, it was an anomaly because we had lower attrition rates across the industry. As I look at attrition rates this year and just the tightening labor market, we're looking at a labor market that actually feels more like a labor market pre-COVID. And not to say it's an exact one to one comparison. But we do see that comparability in the labor markets. So the reality is, we've actually navigated that market. So it sort of gives us comfort that we know how to navigate it.

The other things we're seeing is, the tightening of the labor market is a function of geography. It's a function of skill sets. And it's also a function of where non-labor costs are for every employee that we bring on-board. So as you think about the total bundle of factors, we're developing metrics at the geography level to see are there pockets where there are heightened levels of demand. We're looking at skill sets. As we look about next year's plan, we actually have a sense going into next year's plan where the skill sets are going to be needed and what those markets are fundamentally running in at. So those are metrics we're starting to track to, but no hard metrics to communicate on the phone. But I wanted to be able to share a little more color on all of the other factors that play into this equation.

Q - Tobey Sommer {BIO 6296228 <GO>}

Okay, thank you. My follow up question is more on recompetes. What do recompete percentages look like over the next couple of years, please? And is there or say, are there certain significant programs that we should keep in mind as we map that out?

A - Nazzic Keene {BIO 18292745 <GO>}

I think as we look forward, Tobey, a couple of comments. For the next couple of years, it's more normative. It's more in the 15% to 25% which is a normal year, give or take. And obviously, things get pushed out, as things slide and that changes that metric, especially if they're significant. As we've touched on for next year, the two most significant ones, there's always stuff coming in and coming out of the portfolio. But the two that, that I would bring your attention to are the, it's the NASA recompete that we've touched on giving you an update on that, as well as the Vanguard program which is the Department of State program that we've held for the last 10 years that will go through a bit of a different recompete cycle as we get into mid next year. So we're keeping, obviously you know we're very aggressively pursuing that. But that would be one that I think would be top of mind as we think about the revenue flow for next year.

Prabu, do you have anything to add?

A - Prabu Natarajan {BIO 17701667 <GO>}

PB MRO is up for recompete. But it doesn't have a revenue impact next year, but the following year.

Q - Tobey Sommer {BIO 6296228 <GO>}

Thank you.

Operator

Your next question comes from the line of Louie DiPalma with William Blair.

Q - Louie DiPalma {BIO 20073018 <GO>}

Good morning, Nazzic, Prabu and Joe.

A - Nazzic Keene {BIO 18292745 <GO>}

Good morning.

A - Prabu Natarajan {BIO 17701667 <GO>}

Good morning, Louie.

Q - Louie DiPalma {BIO 20073018 <GO>}

SAIC along with nearly all of your peers have reported significant margin expansion relative to last year. Has work from home flexibility been a driver for your higher margins? And if not, can you just provide an overview on what has been the main catalyst for your margin expansion?

A - Prabu Natarajan {BIO 17701667 <GO>}

Sure. Thank you for the question. For FY23, -- sorry FY22 rather, certainly, there is a dynamic around total costs, which have run lower than planned. And that's true not just for FY22, but it was actually just as true for FY21. We actually called it out as tailwind for FY21 margins, when we sort of gave you the bridge between '21 going into '22. Clearly, how this plays out next year, I'd say that's probably an open question right now.

So as we sort of think about margin rates, we called out a couple of items over the course of the year just as we did in FY21, that were a significant tailwinds to operating margin. We called out nearly 60 basis points to 70 basis points of margin tailwind in FY22, primarily related to the off-market liability pickup that we referred to on our Q2 call. So the way we thought about guidance for FY23 at this juncture is, while we see potential for long-term improvement operating margin rates, we bridged it back to the high 8% range, which is sort of inherently where this portfolio is operating at currently.

But, again recognizing as I've said probably 4 times on this call already, that the team is going to be incentivized to improve margin out of this business. And therefore, we're not going to sit over the course of the year at the high 8% range. And hopefully, we've got our incentives working in the way that it worked in FY22. But we have to be realistic to acknowledge the tailwind from those couple of significant one-time pickups in FY22.

A - Nazzic Keene {BIO 18292745 <GO>}

And Louie, the other thing I would just reinforce and I touched on this a bit ago is, and of course, this takes time. But we're also very focused, as Prabu indicated, and I've talked about in the margin profile of the pipeline. And so, not only in maximizing the margins for the programs that we execute today, but really looking for ensuring that our pipeline is reflective of the margin expansion, again, in aggregate any one program can have an impact one way or the other. But an aggregate in those areas that we have highlighted as being part of our strategy that will in fact, drive higher margins in the portfolio over time as we win and prosecute those.

Q - Louie DiPalma {BIO 20073018 <GO>}

Great, Nazzic. And related to that commentary on the pipeline, are there other hardware type systems production contract in your pipeline, similar to the Navy torpedo MK 48, that you think that you are strongly positioned to win? And for hardware type contracts, is the margin profile consistent with your IT systems integration base type contracts?

A - Nazzic Keene {BIO 18292745 <GO>}

Yeah, Louie. Let me take that and then Prabu can add some color certainly. So the answer is yes. This is an area and it's very consistent with SAIC's heritage and engineering and modernization. And so we do have other potential opportunities of significant size and scale and and strong margins in our pipeline. We are, as I mentioned in my prepared remarks, very selective. And so we want to make sure they are programs in which we absolutely understand the domain. We understand the technology. We have a very strong ecosystem of partners. And and of course, we can contract and deliver the work advantageous to both our customers mission, as well as ourselves.

And so we do have a strong pipeline. It is something we look at. And it really is building on the the very strong complex engineering heritage of SAIC. And then we bring forth some tools, repeatable tools in the form of supply chain management, in the form of digital engineering, digital twins. And so that combination has given us a strong position in the market. So we do have strong opportunity, strong pipeline opportunities, but we are selective. And I think Prabu and I, lay our eyes on every one of those that have any size or scale that go through the pipeline to ensure that it is consistent with our strategy. Prabu?

A - Prabu Natarajan {BIO 17701667 <GO>}

And in terms of the margin, great question. I'd say, the aspiration for margins from this part of the business would be more in line with margins that we see on the hardware side. So think of that as sort of the circa 10% to 14% margins is sort of our aspiration, not to build something that's technically challenging and complex and sell it at 8% or 9% margin rate. So to me, I think that's the aspiration.

We've got a good pipeline of evolving opportunities. But Nazzic and I spend a lot of time on the ROI on these investments to make sure that why SAIC is an important question for us. And if we have the dominant experience and we know what we need to deliver that gives us additional comfort that our legacy here as a systems integrator will actually help us execute and deliver what we need to deliver. So we're very thoughtful about the opportunities we pick on this -- in this space.

Q - Louie DiPalma {BIO 20073018 <GO>}

Excellent, and happy holidays.

A - Nazzic Keene {BIO 18292745 <GO>}

Happy holidays.

Operator

Your next question comes from the line of Sheila Kahyaoglu with Jefferies.

Q - Sheila Kahyaoglu {BIO 17240338 <GO>}

Hi. Good morning, guys. Thanks for the time. So just on the top line, you guys have talked about it a few times already. It seems like there is maybe three contracts that really helped you grow. One of them is risk. The other is maybe some Amcom on contract growth. And is Nazzic, the third one that you mentioned (inaudible) is that all the new work, how should we think about that being incremental? And Prabu, you talked about the recompetes for next year, it just really being the big one and HP, CMP and Vanguard kind of rollover into fiscal '23, '24 potentially. So how do we think about that program completion percentage and recompete percentage delta? So three questions in that one.

A - Nazzic Keene {BIO 18292745 <GO>}

Okay. Prabu, and I can tag team. As I -- the first part of your question on the -- I would say the tailwinds going to next year, the growth in NAVSEA at Mark 48 program, there will be some -- certainly some growth going into next year. It is an existing program on which we're building on. So there will be incremental growth there. On the headwind side, certainly, the Vanguard is a headwind, depending on timing. Obviously, we're going to pursue a significant portion of that. The parts that we believe we have a -- we are well positioned to win, they are going to do some breakup and multi-award.

So it's a bit more complicated than just a line for line recompete. But we feel very strongly positioned in much of that work. And we will certainly pursue that. Timing is key on that, because that certainly does go into -- depends on the timing of the recompete the award into next year as far as the revenue headwind. And then of course, we've talked about the NASA program. So I think you captured most of the headwinds and tailwinds correctly.

Prabu, anything you want to add colors.

A - Prabu Natarajan {BIO 17701667 <GO>}

No, that's perfect.

A - Nazzic Keene {BIO 18292745 <GO>}

Okay. Anything I missed there Sheila?

Q - Sheila Kahyaoglu {BIO 17240338 <GO>}

No, that's all good. And then just on the headcount, you guys grew to -- sorry your top line grew 2% organically and your headcount was flat year-over-year. When we look at some of the other public peers, it looks thy group maybe 3%. I don't know what the industry grew. But kind of how do you think about your growth in the quarter? Was that on contract growth? Was that wage inflation? And it does seem like there is a bit of a delta with your attrition rates versus the industry. But I only have a subset of peers, I look at, you guys look at a broader industry set. So maybe if you could comment on the headcount a little bit more?

A - Prabu Natarajan {BIO 17701667 <GO>}

Yeah, Sheila. I'll take that one. On headcount, I'd say your math sounds about right. I think we were more flat on headcount than at least some of the reported numbers we've seen from our peers. And I would say, we think about this on a total net company basis, which includes programs that end and new programs that ramp. Clearly, as we mentioned in the prepared remarks, the top line for the quarter at 2.1% organic came in a little bit lighter, just based off of the continued tightness we're seeing in the labor market.

So as we think about labor growth year-over-year, we have metrics around what we want that headcount number to be for FY23. As we look back, 2 months or 3 months, and we do this weekly reviews of headcount. What we see are two trends. Labor utilization is up, which is a good sign. Spare time, if you will that's actually flattening out, which is also a good sign. Three, we're not quite seeing the needed headcount curve bend, but we're actually starting to see the needed headcount curve flat. That tells me, we're starting to catch up with what the inherent demand is, internally for headcount. But we're not starting to bend the headcount curve yet. But we do have a robust plan process with a good perspective on what the net increase to headcount needs to be organically for the company to grow next year, and that's what the team is committed to executing. Just a little more color for you.

Q - Sheila Kahyaoglu {BIO 17240338 <GO>}

Okay. Thank you.

A - Nazzic Keene {BIO 18292745 <GO>}

Thanks, Sheila.

Operator

At this time, there are no further questions. I would like to turn the call back over to Mr. Joseph DeNardi for closing remarks.

A - Joseph DeNardi {BIO 22467920 <GO>}

Great. Thank you, Lisa, and thank you all very much for your participation in today's earnings call and for your continued interest in SAIC. Have a nice day.

Operator

This concludes today's conference. You may now disconnect.