

INSIGHTS | JUNE 2015

Cash-Flow Opportunities in the Commercial Aerospace Industry



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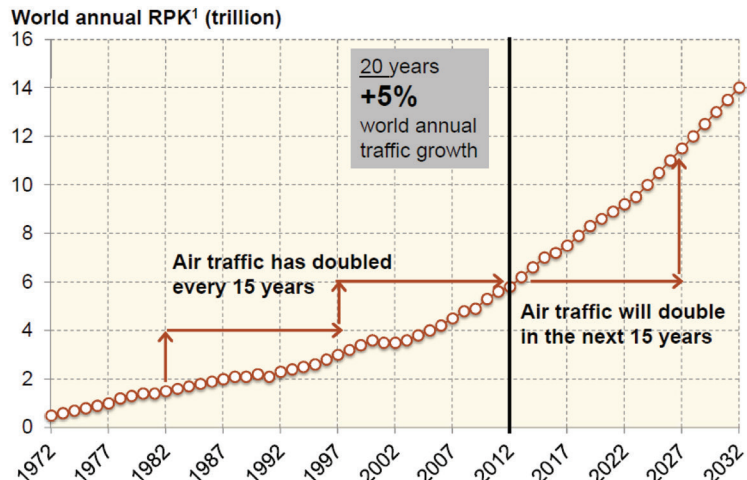
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It is expected that the next twenty years will see a dramatic increase in commercial aircraft production. This will be driven primarily by continued increases in passenger travel demand especially from the developing economies of China and India, as well as the accelerated replacement of obsolete aircraft with next generation more fuel-efficient aircraft. Due to these factors, the commercial aerospace industry has been forecasted to grow at a long-term rate of approximately 5% per year for the next twenty years.¹ This compares favorably to a long-term global GDP growth forecast of only 3%.² Under this scenario, original equipment manufacturers such as Boeing and Airbus, and aviation suppliers such as Safran and United Technologies among others, should benefit from opportunities to grow revenue and cash flow at an above-average rate.

DEMAND FOR AIR TRAVEL IS RESILIENT AND GROWING

Air travel has proven to be highly resilient historically. While the industry has experienced many downturns, recoveries have followed quickly, providing evidence of the value individuals and corporations place on air transportation. As the chart below indicates, air traffic has doubled every fifteen years historically and is expected to double again in the next fifteen years.³ Higher economic growth rates in emerging market countries will provide a surge in air traffic in these regions. The increasing use of air travel due to the rise of the middle-class in the Asia-Pacific region will lend support to this trend.⁴

TRAFFIC WILL DOUBLE IN THE NEXT 15 YEARS

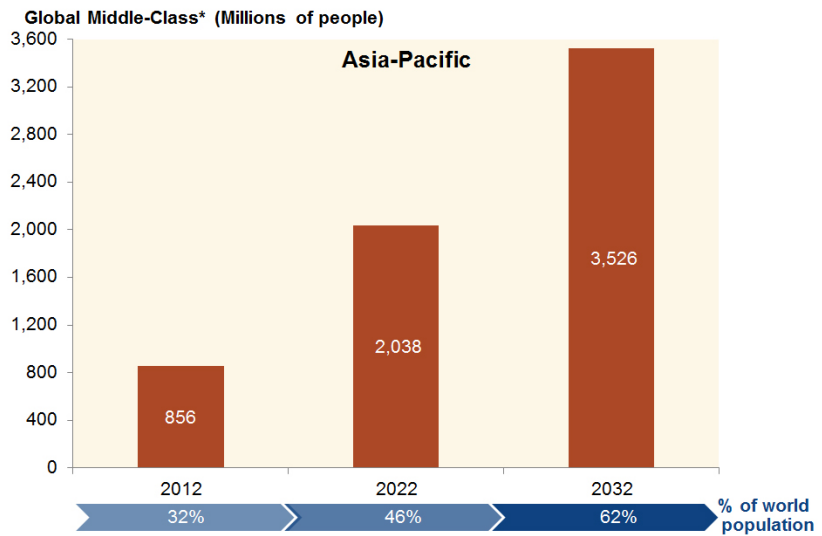


Source: Airbus
¹Revenue Passenger Kilometers

FUEL COST DRIVES ACTIVE REPLACEMENT CYCLE

Replacement need is the major driver of demand for new aircraft in the more mature North American and Western European regions. In the last decade fuel cost has doubled as a percentage of total airline costs. Fuel now represents up to 30% of total operating cost for single-aisle airplanes and up to 50% for wide-body airplanes.⁵ Recent innovations in jet engine fuel efficiency and aviation materials (carbon fiber) have led to operating cost savings of 20% or more. As a result airline companies are now eager to replace older generation aircraft with new, more fuel-efficient aircraft such as the Boeing 787 Dreamliner or Airbus A350, resulting in a vibrant aircraft replacement cycle.⁶

GLOBAL MIDDLE CLASS

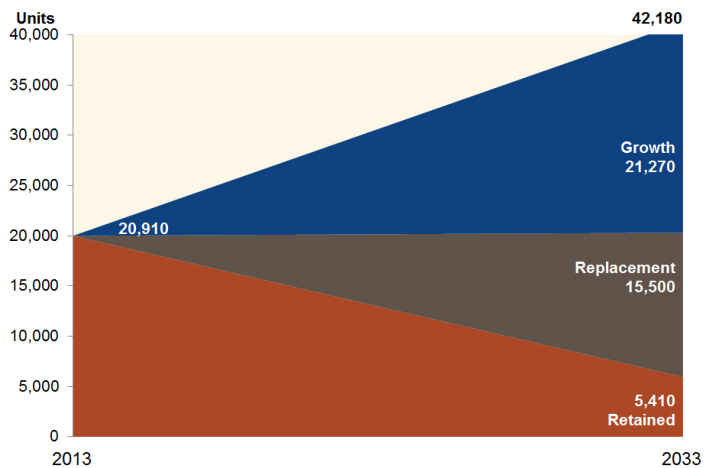


Source: Kharas and Gertz, Airbus
 *Households with daily expenditures between \$10 and \$100 per person (at PPP)

GROWTH AND REPLACEMENT LEADS TO A DRAMATIC INCREASE IN PRODUCTION

Current forecasts suggest that the size of the world’s aircraft fleet will need to double by 2032 in order to meet future demand based on the factors previously highlighted.⁷ A strong production cycle should provide commercial aerospace manufacturers and suppliers with above-average growth opportunities over the long term.

INDUSTRY PRODUCTION FORECAST



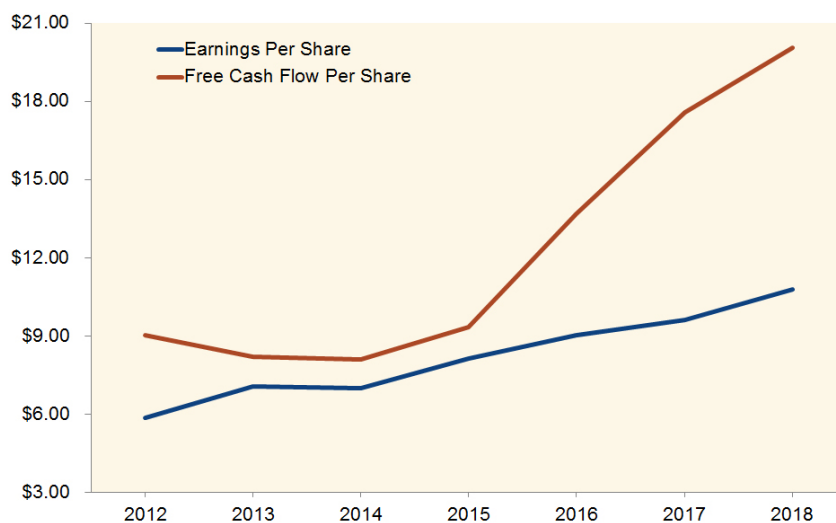
Source: Boeing

OUR APPROACH

Our approach to investing in the aerospace and defense sector is to focus on investments in those companies that have significant exposure to the commercial aerospace industry. For example, Boeing currently has a backlog of commercial aircraft orders equal to over 5,700 aircraft valued at approximately \$502 billion representing over seven years of segment sales.⁸ As a result, forward visibility on revenue and cash flow for Boeing is far superior to many defense industry peers.

Importantly, due to financial accounting rules governing aircraft production, aircraft manufacturers like Boeing often times experience significant variation between reported earnings per share and operating cash flow. As a result, a strict reliance on accounting-related earnings measures can lead to the wrong conclusion from an investment perspective. For example, based on our own analysis Boeing's stock is currently attractive on a free-cash-flow basis, but less so based on accounting-related earnings forecast.

CASE STUDY: BOEING



Source: Epoch Investment Partners, Inc.

CONCLUSION

The commercial aerospace industry is poised to benefit for many years from favorable demographic trends and the demand for more fuel-efficient aircraft. These factors should enable the industry to grow at a faster rate than the global economy as a whole, providing investors with an attractive opportunity.

In order to capitalize on this opportunity investors should focus on those companies within the aerospace and defense sector that will be in a position to grow free cash flow at an above-average rate and subsequently allocate that cash flow for the benefit of shareholders.

¹Boeing, Current market Outlook (2014-2033), September 2014, http://www.boeing.com/assets/pdf/commercial/cmo/pdf/Boeing_Current_Market_Outlook_2014.pdf.

²OECD, Economics Department Policy Note No. 15, Looking to 2060: A Global Vision of Long-Term Growth, November 2012, <http://OECD.org/economy/outlook/2060policynote.pdf>.

³Airbus, Global Market Forecast, Future Journeys 2014-2033, September 2014, <http://www.airbus.com/company/market/forecast/>

⁴Ibid.

⁵Boeing, Current market Outlook (2014-2033), September 2014.

⁶International Air Transportation Association (IATA), Technology Roadmap 4th Edition, June 2013, Page 56 <http://www.iata.org/whatwedo/environment/Documents/technology-roadmap-2013.pdf>.

⁷Boeing, Current market Outlook (2014-2033), September 2014, and Airbus, Global Market Forecast, Future Journeys 2013-2032, September 2013

⁸Boeing, <http://boeing.mediaroom.com/2015-01-28-Boeing-Reports-Record-2014-Revenue-EPS-and-Backlog-and-Provides-2014-Guidance>.

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