Meggitt

Forecast cuts, buyback

Q3 IMS: Slow trading, but quick buyback launch

Aerospace & defence

Meggitt's IMS was a curate's egg: a pretty material cut to 2015 guidance, coupled with an admission that surplus/cannibalised aircraft parts are probably a far broader and systemic threat to the aftermarket than had been assumed. However, the surprise unveiling of an immediate share buyback, albeit only c 6% of the share capital, both reduces the near-term likelihood of a major acquisition and demonstrates that the board understands both this risk and the undesirable impact of an over-strong balance sheet. The shares trade at a premium to their aero engine peers, a level that could be supported over the next c 12 months by the buyback.

Year end	Revenue (£m)	EBIT (£m)	PBT* (£m)	EPS* (p)	P/E (x)	Yield (%)
12/13	1,637	397	340	32.8	14.5	2.7
12/14e	1,517	330	302	29.5	16.1	2.8
12/15e	1,575	353	323	32.5	14.7	3.0
12/16e	1,650	380	349	36.4	13.1	3.2

Note: *PBT and EPS are normalised, excluding intangible amortisation, exceptional items and share-based payments.

Q314 IMS: Swings and roundabouts

Q3 saw very strong civil original equipment (OE) growth (sales +18%), but this typically has far lower margins than the aftermarket (+4%). Despite a recovery in Defence (+5%), we suspect that the FY outcome will remain dominated by the adverse dollar exchange rate, while Energy continues to disappoint, with a total $25m of Brazilian work now delayed into 2015. The announcement of a share buyback was a very positive surprise, and sends a strong signal about the board's attitude to the capital structure, as well as the reduced near-term likelihood of a major acquisition.

Below-average growth for 2015e: Our forecasts cut

We have cut our revenue and earnings forecasts by 9-18%, reflecting our over-optimism about the pace of Meggitt's aftermarket growth, and the company's reduced guidance for 2015. We now see the availability of aircraft spare parts and systems that have been recovered from scrapped aircraft as having a broad and systemic impact on Meggitt's aftermarket business. We have also been disappointed by the reversal at Heatric, which Meggitt now forecasts to have a weak 2015, notwithstanding the shift of revenues from 2014 into that year.

Modelling the buyback: Still room for M&A

The buyback is not terribly ambitious: to meet the end-2015 target of >1.5x net debt:EBITDA, we calculate that Meggitt can spend £245m, buying 50m+ shares, and reducing the share count by c 6%. Meggitt could, therefore, still afford a cash acquisition of £1bn+, given its new 4x EBITDA banking covenants. However, the fact that the company has decided to do the buyback now sends a strong signal to us that Meggitt can see no major deals likely in the near to medium term that fit its twin criteria of being a good industrial fit and attractively valued. We see this "risk off" message as a major driver of the very positive share price response.

10 November 2014

Price	476.2p
Market cap	£3,853m
Net debt at end H114	£568m
Shares in issue	809.2m
Free float	100%
Code	MGGT
Primary exchange	LSE

Share price performance

%	1m	3m	12m
Abs	9.1	(0.4)	(6.2)
Rel (local)	7.8	(0.2)	(4.7)
52-week high/low		546.5p	423.9p

Business description

Meggitt produces a wide range of components and sub-systems, largely for civil aircraft (45% of 2013 sales) and defence (38%); energy is the largest other area (11%). Key applications for its sensors are in aircraft engines, fuel systems and fire detection. Wheels and brakes equip business and regional jets, as well as some larger military and civil aircraft. Aerospace original equipment sales (40% of H114) build an installed base that drives long-term aftermarket sales (41%), generating 20%+ margins and giving Meggitt some of the characteristics of an aero engine company.

Next events

2014 preliminary results	March 2015 (tbc)

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Q314 IMS: In line, and a dull outlook for 2015

Q314: Aerospace up, Brazil and FX take it all away again

Meggitt's IMS for the first nine months of 2014 highlighted a good Q3, with strong civil OE growth (+18%), the predicted recovery in the civil aftermarket (+4%) and a recovery in defence (+5%). However, at the group level this was largely eliminated by Energy (down 7%), with deferrals of up to $25m of contracts into 2015 and supplier problems in Brazil, as well as a still-substantial hit from FX. Meggitt's forecast of low single-digit organic growth for FY14 looks little different from that given at the interims, implying a down year at the headline level after the effects of FX.

First look into 2015: More of the same

Perhaps more significant is the forecast of similar low organic growth in FY15, implying that the pretty slow Q414 trading is likely to persist through 2015. This is not a BAE/Rolls-style "growth pause", but it is still a bit of a disappointment compared to our previous expectations of accelerating growth, driven by a combination of rising new civil aircraft build rates (for Controls and Sensors) and increasing fleet utilisation (for Wheels & Brakes).

Parting out and surplus parts use is becoming an intensifying headwind

A key challenge for Meggitt appears to be an increasing use by airlines of cannibalised and refurbished spare parts, a process that can often completely bypass Meggitt's own maintenance, repair and overhaul (MRO) facilities.

This is a phenomenon that Safran has highlighted over the last 18 months; it has seen increasing parting out of early model CFM-56-3 engines (for the Boeing 737 Classic), sharply depressing airline demand for OEM spares and engine repairs.

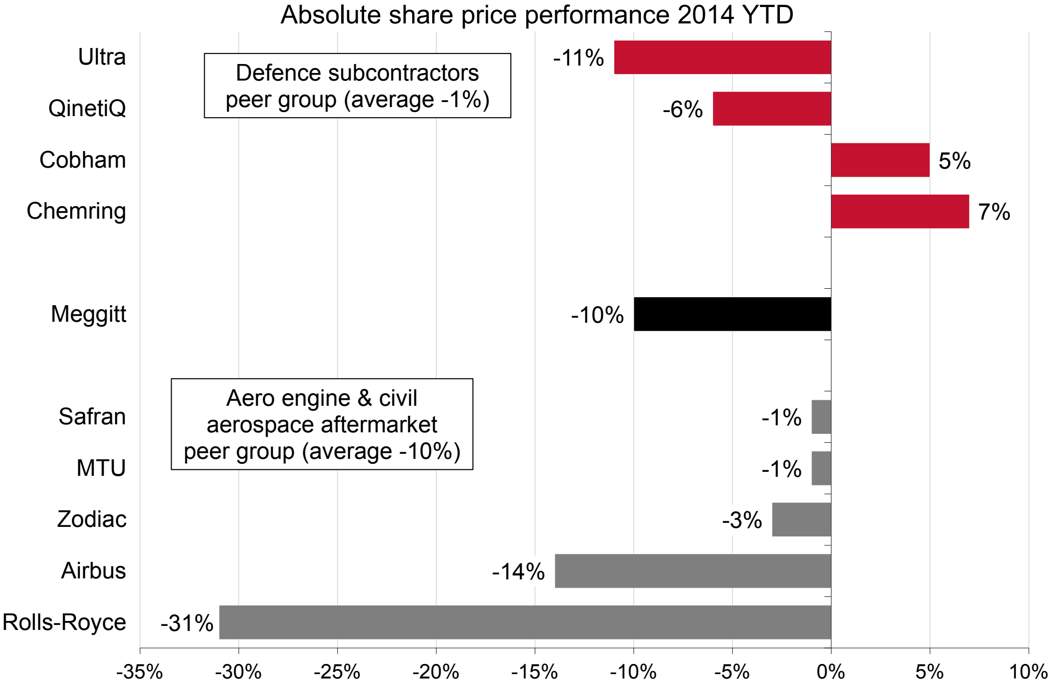
We believe that the same parting out of an engine is also releasing part-used Meggitt sensors and valves, while parting out of complete airframes can clearly release wheels and brakes. This may be a particular issue for Meggitt for regional aircraft that have a large parked fleet, especially Bombardier CRJs and BAE146s/RJs.

The share buyback is a positive surprise

The real surprise of the statement to us was the board's decision to start a share buyback from 6 November 2014. We have highlighted previously (see our note of 4 March 2014) that Meggitt's balance sheet has become very ungeared. We therefore thought that there was an increasing risk that the company might undertake another large acquisition. We think the decision to do a buyback suggests that Meggitt's board:

- accepts that the talk of a large deal that has persisted since the FY13 results has actually acted as an overhang on the share price (see Exhibit 1);
- cannot find an acquisition worth doing; and
- thinks that, if Meggitt can find a large acquisition, it can as easily be funded by equity, and therefore a relatively ungeared balance sheet is not necessary.

Exhibit 1: Meggitt has the product breadth and customer range of a subcontractor but the strong aftermarket content of an aero engine company; even after the post-Q3 IMS share price bounce, Meggitt's ytd performance has been far closer to the civil aerospace peers



Source: Bloomberg data, Edison Investment Research. Note: Share price performance as at 6 November 2014.

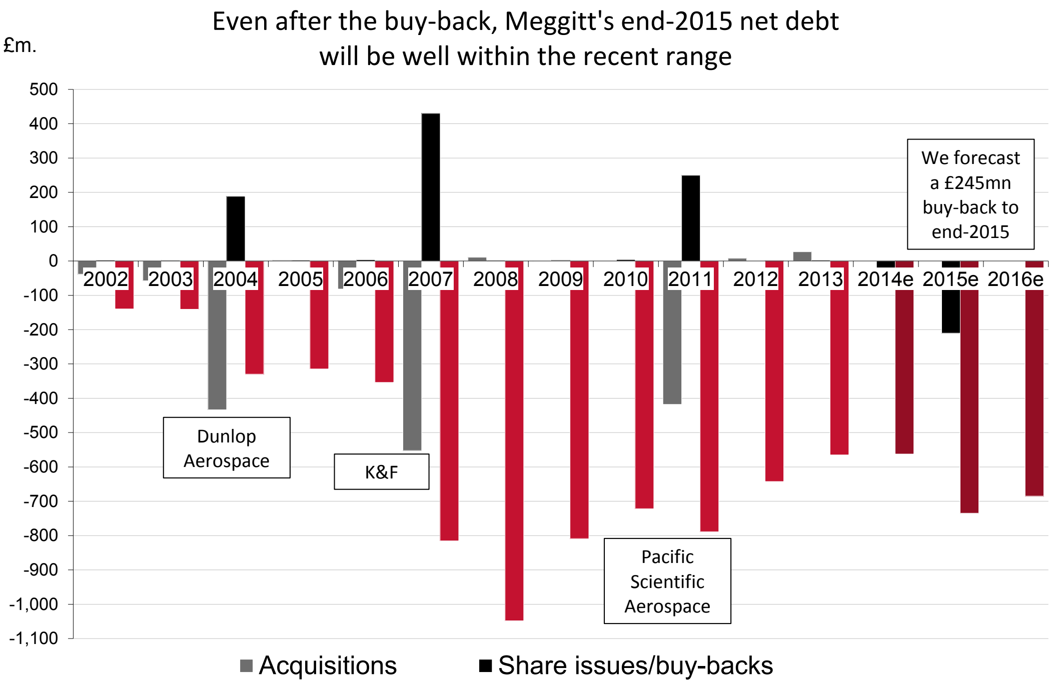
Meggitt has stated that its target is to buy back enough shares to bring its net debt to equity to around or slightly above 1.5x EDITDA by end-2015, well within the target 1.5-2.5x range. On our revised forecasts we calculate this to equate to a year-end debt level of around £720-730m.

- We calculate that Meggitt can, therefore, afford to spend around £245m on the buyback.
- This could, at current prices, amount to some 52m shares, reducing the share count by c 6%.

The buyback does not rule out deals: Meggitt can still afford up to £1.1bn

We highlight, however, that even after the buyback, Meggitt will still have net debt comfortably within its recent range. And, with the renegotiated banking covenants now giving the company an "acquisition spike" of up to 4x net debt:EBITDA for up to a year, Meggitt could afford to spend up to £1,070m of cash on an acquisition, provided it could generate cash and/or raise equity within the following 12 months. So the buyback does not preclude an acquisition, it just makes the balance sheet marginally more efficient in the near term.

Exhibit 2: Meggitt has traditionally done large deals, part-refinanced with equity, and then generated cash as integration benefits have come through



Sources: Company historical data, Edison Investment Research estimates

Forecast cuts: Reflecting a slower 2015 and surplus parts

We have cut our EPS estimates for Meggitt by 18% for 2014e, 16% for 2015e and 11% for 2016e. These extensive revisions reflect:

- the Q3 IMS, and specifically the weaker than hoped for aftermarket, Brazilian Energy deferrals (now totalling $25m), and a likely slowing Q4;
- the weak guidance for Energy in 2015. Despite the deferrals of work from 2014, Meggitt admitted that, absent this work, Heatric would likely have had a down year in 2015; we had forecast 10%+ growth, in line with Meggitt's medium-term targets;
- generally subdued guidance for Aerospace in 2015. We highlight that the guidance for low- to mid-single-digit organic growth is significantly below the target in the 2013 Report & Accounts of 6-7% and our forecasts at that time of 8-9%;
- Meggitt's lower guidance suggests to us that surplus parts are a persistent and material factor depressing aftermarket demand. Given the typically far higher margins on aftermarket sales, especially spare parts, we model a magnified effect on EBIT; and
- we model the effects of a £245m buyback of 50m shares, with a small impact in 2014e, more in 2015e and a full-year effect in 2016e. This effect can be seen clearly in the divergence between the cuts in EBIT compared to those in EPS.

Exhibit 3: Forecast revisions

	Sales (£m)			EBIT (£m)			EPS (p)		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
2014e	1,675	1,517	-9%	401	330	-18%	36.1	29.5	-18%
2015e	1,780	1,575	-12%	424	353	-17%	38.6	32.5	-16%
2016e	1,900	1,650	-13%	450	380	-16%	40.8	36.4	-11%

Source: Edison Investment Research estimates

Exhibit 4: Meggitt summary financial record, forecasts, capital structure and valuation

Share price (p)	473					
Shares in issue (m)	809					
£m	**2011**	**2012**	**2013**	**2014e**	**2015e**	**2016e**
Revenues	1,455	1,606	1,637	1,517	1,575	1,650
Operating profit	360	392	397	330	353	380
Pre-tax profit	307	350	340	302	323	349
Normalised EPS (p)	29.8	34.4	32.8	29.5	32.5	36.4
DPS (p)	10.5	11.8	12.8	13.5	14.4	15.3
Shareholders' funds	1,793	1,905	2,076	2,204	2,345	2,503
Depreciation	69	74	84	91	99	104
EBITDA	429	466	482	421	452	484
Net debt (incl pension deficit)	(1,108)	(942)	(803)	(823)	(995)	(946)
Enterprise value	4,935	4,769	4,629	4,650	4,822	4,772
P/E (x)	15.8	13.8	14.4	16.1	14.6	13.0
EV:EBITDA (x)	11.5	10.2	9.6	11.1	10.7	9.9
EV:sales	*339%*	*297%*	*283%*	*307%*	*306%*	*289%*
Operating margin	*24.7%*	*24.4%*	*24.3%*	*21.8%*	*22.4%*	*23.0%*
Dividend yield	*2.2%*	*2.5%*	*2.7%*	*2.9%*	*3.0%*	*3.2%*
Gearing	*62%*	*49%*	*39%*	*37%*	*42%*	*38%*
Net debt:EBITDA (x)	1.8	1.4	1.2	1.3	1.6	1.4

Source: Company historical data, Edison Investment Research estimates and calculations. Price at 6 November

Valuation: Higher margins, also some higher multiples, than aero engine peers

We value Meggitt against what we regard as its direct European aerospace & defence peers: the three aero engine companies, Rolls-Royce, Safran and MTU.

- We use this peer group because we regard Meggitt's business model, with a high level of civil aerospace aftermarket sales, as being far closer to an engine company than to a defence subcontractor with similar margins such as Ultra Electronics.
- We also see Meggitt's aircraft wheels and brakes business, which provides parts free of charge for the original delivery, and then makes money from the subsequent high-margin repair and overhauls, as being near-identical to the long-term service agreements of the engine companies.

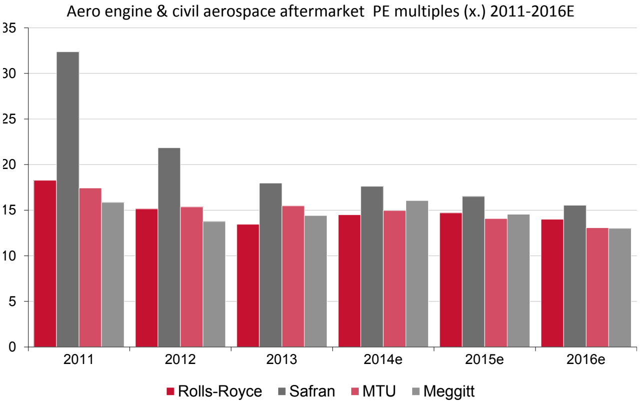
This latter element of Meggitt's business is, we believe, a significant distorting factor in Meggitt's valuation metrics:

- The free of charge (FOC) nature of the wheels and brakes business means that reported revenues for the division (we forecast £320m in 2014e, 21% of group) are c 80% aftermarket, and only c 20% OE.
- Capitalisation of the FOC element inflates reported margins (Aircraft Braking Systems divisional margins are 37%, by far the highest in the group).

Together, these drive some (but not all) of the massive discrepancy in EV:sales and EBITDA multiples compared to the engine companies.

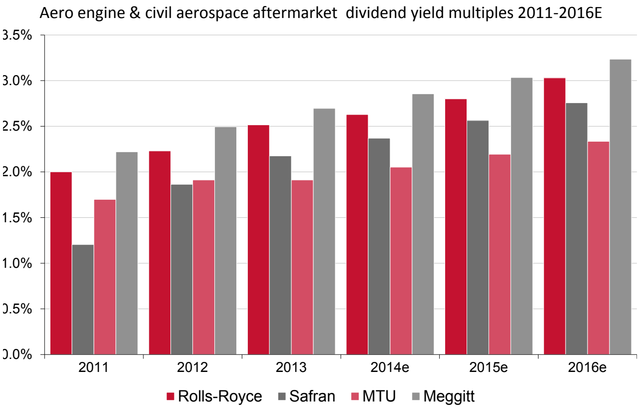
The most obvious value that Meggitt shows at present is in terms of dividend yield; we forecast c 6% pa dividend growth, which gives a yield of c 3%, compared to a c 2.5% average for the engine companies.

Exhibit 5: Meggitt's P/E multiples are broadly in line with MTU…



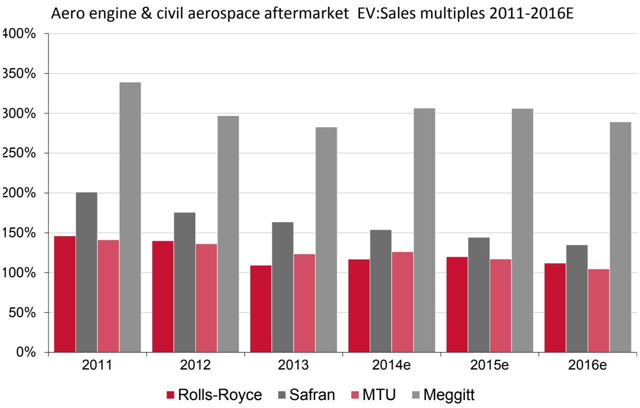
Source: Edison Investment Research estimates

Exhibit 6: …but its yield premium is increasing over the engine companies



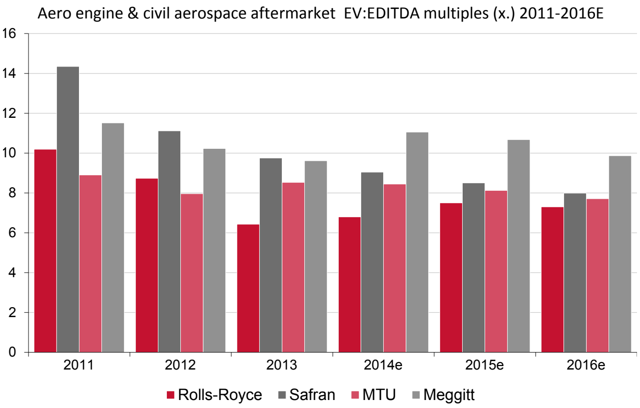
Source: Edison Investment Research estimates

Exhibit 7: Meggitt's EV:sales is far above any of the engine companies…



Source: Edison Investment Research estimates

Exhibit 8: ….and its high reported margins also drive the EBITDA premium



Source: Edison Investment Research estimates

Exhibit 9: Meggitt summary earnings model

Year to end-December, £m	2011	2012	2013	2014e	2015e	2016e
Revenues						
Aircraft Braking Systems	321	311	330	320	335	360
Control Systems	202	215	364	330	345	360
Polymers & Composites	171	187	181	157	165	175
Sensing Systems	234	240	398	380	395	410
Equipment Group	528	652	364	330	335	345
Total	**1,455**	**1,606**	**1,637**	**1,517**	**1,575**	**1,650**
		10%	2%	-7%	4%	5%
Underlying operating profit						
Aircraft Braking Systems	120	117	122	120	127	135
Control Systems	48	50	108	95	100	105
Polymers & Composites	32	34	30	25	27	30
Sensing Systems	43	36	70	45	51	58
Equipment Group	117	155	67	45	48	52
Total operating profit	**360**	**392**	**397**	**330**	**353**	**380**
		9%	1%	-17%	7%	8%
Operating margin						
Aircraft Braking Systems	37.4%	37.6%	37.0%	37.5%	37.9%	37.5%
Control Systems	23.8%	23.2%	29.6%	28.8%	29.0%	29.2%
Polymers & Composites	18.5%	18.1%	16.7%	15.9%	16.4%	17.1%
Sensing Systems	18.5%	15.1%	17.6%	11.8%	12.9%	14.1%
Equipment Group	22.1%	23.8%	18.4%	13.6%	14.3%	15.1%
Group operating margin	**24.7%**	**24.4%**	**24.3%**	**21.8%**	**22.4%**	**23.0%**
Restructuring & exceptionals	(20)	(17)	(37)	(10)	(11)	(12)
Net underlying finance costs	(32)	(26)	(19)	(18)	(19)	(19)
Profit before tax	**307**	**350**	**340**	**302**	**323**	**349**
Tax paid	(78)	(81)	(81)	(66)	(70)	(75)
Tax rate	25%	23%	24%	22%	22%	22%
Attributable income	230	269	260	235	252	274
Shares in issue (m)	770	782	791	799	777	752
Statutory EPS (p)	24.0	30.1	29.4			
Normalised EPS (p)	**29.8**	**34.4**	**32.8**	**29.5**	**32.5**	**36.4**
change y-o-y	10.8%	15.2%	-4.6%	-10.2%	10.3%	12.0%
Meggitt "Underlying EPS" (p)	31.9	36.5	37.5			
change y-o-y	14.7%	14.4%	2.7%			
Net dividend (p)	**10.5**	**11.8**	**12.8**	**13.5**	**14.35**	**15.30**
change y-o-y	14.1%	12.4%	8.1%	5.9%	6.3%	6.6%

Source: Meggitt historical data, Edison Investment Research estimates

Exhibit 10: Meggitt's cash flow and debt record and forecasts

Year to end-December, £m	2011	2012	2013	2014e	2015e	2016e
Attributable profit	**202**	**250**	**249**	**235**	**252**	**274**
Adjustments for:						
Tax	41	46	37	39	42	46
Depreciation & amortisation	144	155	159	169	179	189
(Profit) on property/business disposals	-2	-3	-10			
Finance income	-37	-2	0			
Finance costs	73	42	31	32	33	34
Financial instruments	-10	-23	-6	3		
Pension payments	-26	-25	-27	-33	-34	-35
Share-based expenses	8	12	12	13	14	15
Change in working capital	2	-43	-82	-90	-95	-100
Exceptional items	-17	-15	-16	-10	-11	-12
Cash flow from operations	**379**	**394**	**346**	**358**	**380**	**410**
Net interest	-31	-28	-19	-18	-19	-19
Cash tax paid	-43	-35	-44	-26	-25	-30
Cash inflow from operating activities	305	332	282	313	336	361
Net cost of acquisitions & disposals	-418	8	27	0	0	0
Net capitalisation of R&D and PPCs	-74	-88	-106	-115	-125	-135
Net capital expenditure	-45	-63	-67	-60	-65	-65
Cash outflow from investing	**-537**	**-144**	**-146**	**-175**	**-190**	**-200**
Cash dividends paid	-48	-72	-76	-101	-108	-111
Issue/buyback of shares	250	1	3	-35	-210	
Net financing	74	-105	-50	0	0	0
Cash inflow/(outflow) from financing	**275**	**-176**	**-123**	**-136**	**-318**	**-111**
FX & Other	37	-1	-2			
Change in cash	44	11	13	2	-172	50
Change in Balance Sheet Net Debt	**-67**	**118**	**65**	**2**	**-172**	**50**
Cash & equivalents	95	105	116			
Short-term debt	-8	-130	-10			
Long-term debt	-875	-617	-671			
Net (debt)/cash	**-788**	**-643**	**-565**	**-562**	**-735**	**-685**
Pension deficit	-320	-300	-238	-261	-261	-261
Adjusted net (debt)	**-1,108**	**-942**	**-803**	**-823**	**-995**	**-946**

Source: Company historical data, Edison Investment Research estimates

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