EDISON

GKN

Aerospace sites visit

Aerostructures: A tale of two cities

Aerospace & Automotive

A visit to two of GKN's flagship aerospace sites highlighted both positives (skills in complex subassemblies constructed from especially challenging materials, and supply chain management) and negatives (the burden of building up volume and reducing quality problems on the A350 and A400M wing spars). Our key conclusions are that very high levels of work in progress suggest some risk to 2014e cash flow, but this could reverse faster than expected in 2015e. In the near term, we think GKN has its work cut out to address the ongoing quality, rate and production issues at the two sites to Airbus's full satisfaction, despite that company's conflicted position as both end-customer and supplier of major components.

Year end	Revenue (£m)	Trading profit (£m)	EPS* (p)	Dividend (p)	P/E (x)	Yield (%)
12/12	6,904	553	26.3	7.2	14.4	1.9
12/13	7,594	661	28.7	7.9	13.2	2.1
12/14e	7,710	694	28.4	8.4	13.3	2.2
12/15e	8,095	749	30.4	9.0	12.4	2.4
12/16e	8,709	820	32.9	9.8	11.5	2.6

Note: *PBT and EPS are management basis, as reported by GKN.

Two sites separated by only a few miles, but a century of tradition

GKN's two major aerospace sites in the Bristol, UK area provide an interesting 'compare and contrast' as to the different routes the company has taken to build up the division. Filton, acquired from Airbus in 2008-09, epitomises "old aerospace": legacy (albeit very high volume) Airbus metallic aerostructures work in "traditional" facilities. Western Approach is a greenfield site that cost as much, and just produces advanced composite wing spars for the A350 and A400M airlifter.

Civil programmes drive GKN Aerospace now

While GKN still has some very high shipset value military contracts, many of these (eg C-17, F/A-18) are close to completion. We estimate that GKN's top six commercial aircraft programmes have aggregate annual revenues of >$1.5bn, and are growing at 5-7% pa. This compares to our estimate of c $400m total annual value for the top eight military aircraft and helicopter programmes, production rates of which are no better than flat in total.

Peer problems: Is Bombardier an acquisition target, or just a potentially disruptive competitor?

GKN has previously suggested that at group level, management feels ready and able to carry out another major acquisition, with aerospace a favoured market. Bombardier of Canada has indicated its willingness to "participate in industry consolidation". We note, however, the Canadian company's guidance for c 4% Aerostructures division operating margins (on $1.8bn of revenues) compares very unfavourably with the 11%+ margins that we forecast for GKN Aerospace in 2014.

16 February 2015

Price	379p
Market cap	£6.2bn
Net debt (£m) at end 2014e	576
Shares in issue	1,643m
Free float	100%
Code	GKN
Primary exchange	LSE

Share price performance

%	1m	3m	12m
Abs	6.2	19.1	(5.8)
Rel (local)	0.9	15.0	(12.7)
52-week high/low		411p	288p

Business description

GKN is a diversified engineering manufacturer. Driveline produces constant velocity joints, driveshafts and all-wheel drive systems. Aerospace products include engine components and aerostructures. Powder Metallurgy includes both sinter metal components and powders. Land Systems produces power transmission systems for the agritechnical, construction and mining markets.

Next events

FY14 results	24 February 2014

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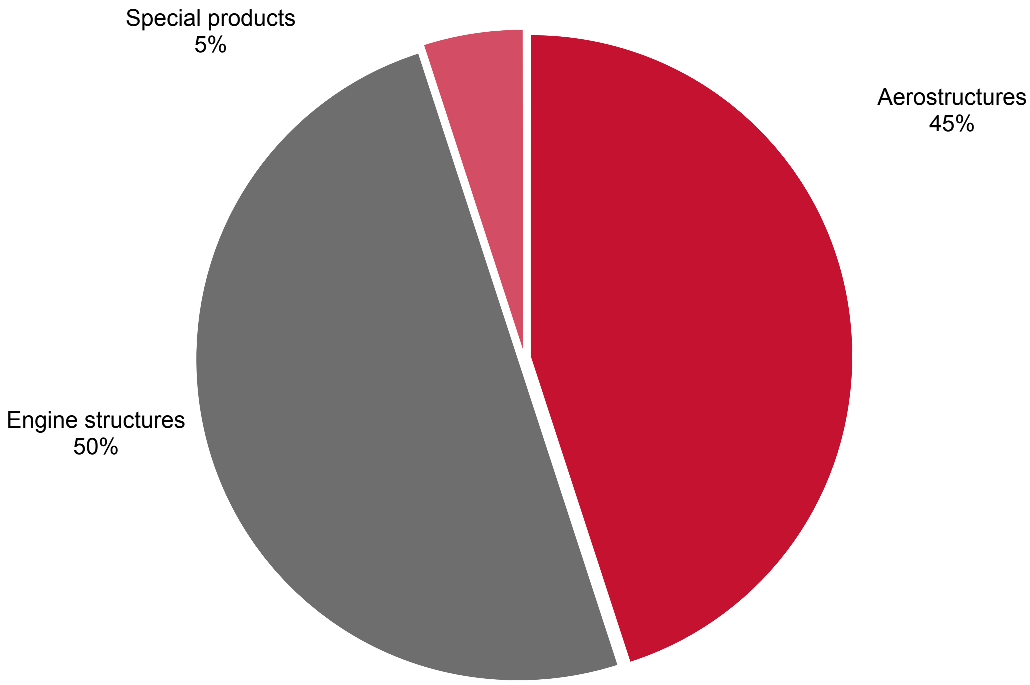
A tale of two cities

Our view

A visit to two of GKN's flagship aerospace sites near Bristol highlighted both the company's positives (skills in complex subassemblies constructed from especially challenging materials, including titanium and composites, and supply chain management) and negatives (the burden of building up volume and reducing quality problems on the A350 and A400M wing spars). Our key conclusions are that almost alarming levels of work in progress at the Western Approach facility suggest some downside to 2014e cash flow, but this could reverse faster than expected in 2015e. In the near term, we think GKN has its work cut out to address the ongoing quality, rate and production issues at the two sites to Airbus's full satisfaction, despite the company's conflicted position as both end-customer and supplier of major components. GKN has previously suggested that at group level, management feels ready and able to carry out another major acquisition, with aerospace a favoured market. We note that Bombardier has indicated its willingness to "participate in industry consolidation" with its FY14 results and financing plan. We note, however, the Canadian company's guidance for c 4% operating margins (on $1.8bn of revenues) compares very unfavourably with the 11%+ margins that we forecast for GKN Aerospace in 2014.

Exhibit 1: Following the £633m Volvo Aerospace acquisition in 2012, GKN Aerospace is balanced between engine components and aerostructures



Source: GKN, based on 2013 Aerospace revenues

Two Aerospace sites contrast buy vs build as routes to growth

GKN's two major sites in the Bristol area provide an interesting 'compare and contrast' as to the different routes the company has taken to build up its Aerospace division.

Filton: A legacy site, with very high-volume Airbus work

Filton was acquired from Airbus in 2008-09 for £136m (plus a commitment to invest a further c £125m) as part of Airbus's Power8 restructuring and divestments process. The activities acquired remain tightly squashed onto the far larger Filton airfield site, along with Airbus, BAE Systems, MBDA and a number of smaller suppliers.

The assets, 1930s brick-built buildings with the remains of WW2 camouflage paint on the outsides, and the largely Airbus programmes inherited, very much represent "older aerospace": generally metallic components and assemblies, with high-touch labour content (1,300 out of c 1,800 GKN employees on site). With sales of £387m, we estimate Filton to be the largest single site in GKN Aerospace.

The very high manufacturing volumes (especially for the A320 family of narrow-bodied aircraft, running close to 46 shipsets a month) and focus on machined components suggests to us this is a business whose value GKN should be excellently qualified to maximise: in essence, this is a high value-added machining and assembly business, with added challenges of supply chain management. It is not, we would argue, wildly dissimilar to the constant velocity joint capabilities in GKN Automotive.

Western Approach: Shiny new, and still squeaking

Western Approach, by contrast, is as new as it gets in Aerospace, both in terms of technologies (carbon composites, and assembly of mixed materials, ie composites with titanium, nickel and aluminium components) and in terms of the manufacturing plant itself (a £170m greenfield site with a high density of brand new machinery, autoclaves, tooling and automation).

It was purpose-built to produce the Airbus A350 wing spar and fixed trailing edge, and now also includes the similar spar for the A400M airlifter. However, with both these programmes at the early stages of their production ramp-ups (and even earlier stages of maturity and profitability), we estimate 2014 revenues could have been as low as £25m, and utilisation only about 20% of the maximum capacity as both programmes reach peak rate in 2017-18.

Key takeaways arising from the visit: More spars than *Master and Commander*

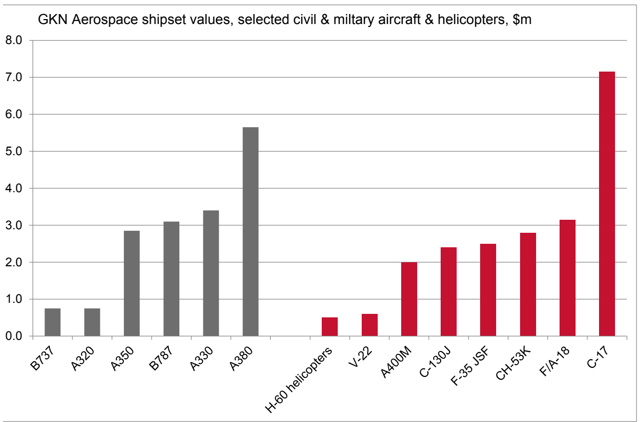
In their different ways both these sites epitomise what GKN, as a broad manufacturing company, can do very well: namely, invest in brand-new technology for a long-term programme and maximise the efficiencies in high-volume legacy work. However, we were struck by several issues, which shape our expectations for the FY14 results (due on 24 March) and 2015 forecasts:

- **Filton's workload, and operational leverage, is dominated by the A320**. As by far Airbus's highest-volume programme (currently Rate 46 and likely to go beyond Rate 50 in the coming years), this aircraft family provides the volumes that appear to us to drive changes in profitability over the coming years.
- We were struck by the degree to which Airbus, and hence GKN, appears successfully to have addressed the transition to the A320NEO (new engine option) family.
- **However, a key risk is the degree to which GKN is in effect 'sandwiched' by Airbus**, which is both the customer for the vast majority of output from both plants, and provides a large

proportion of the metallic subassemblies (ie brackets, mounts and cantilevers) for the wing assemblies. Airbus has several times made public its displeasure with GKN, among a number of other sub-primes, especially on the A350 and A400M programmes. The degree to which Airbus is inherently compromised does, however, suggest to us that Airbus's leverage against GKN in the event of delays to deliveries may be materially less than some investors fear.

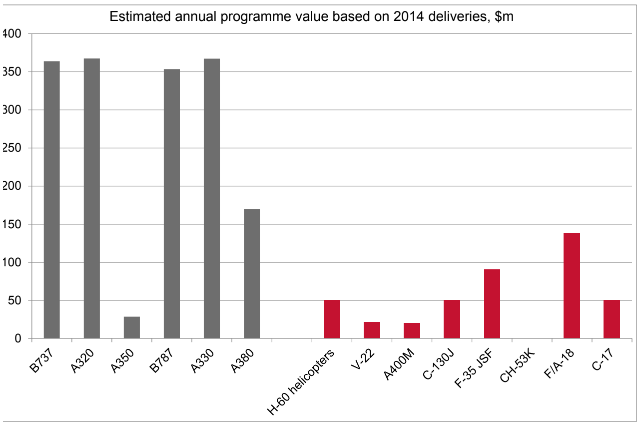
- **GKN has, however, fewer excuses for what appear to be production glitches and quality challenges at Western Approach**. These revolve around the production and assembly of the composite spars for the A350 and A400M, a process that is still at a very early stage for both programmes (we estimate only c 30 shipsets have been delivered for each programme to date). The manufacturing process for the spars is both capital-intensive and remarkably hard to get right and standardise, especially for the A400M, which uses the rather older automated tape laying (ATL) compared to the newer (and perhaps slightly more consistent) advanced fibre placement (AFP) for the A350. We were alarmed, however, by frankly astonishing levels of work in progress at Western Approach: as many as 30 shipsets of spars lying around, some built as buffer stock, but many others waiting for key machine tools to be repaired. Our assessment is that, at the margin, GKN Aerospace might disappoint in terms of 2014e cash flow on account of this work in progress. Its reversal in 2015, if GKN can rectify the various bottlenecks, could drive strong cash flow, by contrast.
- **Filton is the centre for GKN's development in Additive Manufacturing**, which offers the ability to replace complex and over-heavy machined metallic parts and assemblies with purpose designed '3D-printed' components. This is fantastic stuff, and GKN is almost evangelical about the technologies and capabilities. We are more cautious, having been subject to very similar enthusiasm from senior GKN management over the potential use of composites across defence, helicopters, aerospace and automotive at the time of the Westland acquisition. Our recollection is that it took over a decade for the technology to achieve a material impact (ie 10% of revenues) at the group level and the potential outside aerospace was never achieved.

Exhibit 2: GKN's key commercial and military aircraft programmes have a similar spread of shipset values…



Source: Edison Investment Research, derived from GKN Aerospace

Exhibit 3: …but annual civil volumes are far higher, giving total programme values nearly 4x as large



Source: Edison Investment Research, manufacturers' disclosures

Is Bombardier Aerostructures an acquisition target or disruptive competitor for GKN Aerospace?

On 12 February Bombardier of Canada (BBD/B CN) announced that it is prepared to "explore other initiatives such as certain business activities' potential participation in industry consolidation in order to reduce debt". We highlight that one of the three newly separated aerospace divisions in the company is Bombardier Aerostructures, a business that is very similar in technologies to GKN's aerostructures activities. Bombardier guides that this division should have 2015 revenues of c $1.8bn, and produce c 4% operating margins.

- We highlight that this level of profitability is around one-third the c 11% level we forecast for GKN Aerospace in 2014.
- GKN management has, as recently as the H114 results, stated that it could look to do a new large acquisition, with the aerospace sector highlighted as having attractive characteristics.
- We note, however, that Bombardier Aerostructures, while superficially an apparent turnaround candidate, has nearly three-quarters of its revenues with other Bombardier aerospace companies – business jets (Learjet and Challenger) and regional aircraft (Q400 turboprops, CRJ and C Series jets).
- We see an emerging risk to GKN Aerospace in that, in attempting to diversify further (Bombardier management explicitly talked about wanting to win more Boeing and Airbus subcontracting work), Bombardier Aerostructures could become a disruptive pressure in the industry.

FY14 results due on 24 February

Exhibit 4: GKN summary historical record, financial structure & estimates

£m		2012	2013	2014e	2015e	2016e
Share price p.	379					
Shares in issue m.	1,643					
Market capitalisation	6,227					
Sales		6,904	7,594	7,710	8,095	8,709
Trading profit		553	661	694	749	820
Trading profit margin		8.0%	8.7%	9.0%	9.3%	9.4%
Pre-tax profit		493	578	607	670	749
EPS (management basis, p)		26.3	28.7	28.4	30.4	32.9
DPS (p)		7.2	7.9	8.4	9.0	9.8
Net debt		(871)	(732)	(576)	(334)	(59)
Shareholders' funds		1,574	1,775	2,104	2,456	2,838
Pension deficit		(978)	(1,271)	(1,221)	(1,171)	(1,121)
Total debt (including PF deficit)		(1,849)	(2,003)	(1,797)	(1,505)	(1,180)
Total debt: shareholders' funds		(117%)	(113%)	(85%)	(61%)	(42%)
Enterprise value		8,076	8,230	8,024	7,732	7,407
PE		14.4	13.2	13.3	12.4	11.5
Dividend yield		1.9%	2.1%	2.2%	2.4%	2.6%
EV/Sales		117%	108%	104%	96%	85%
EV/EBITDA		9.8	8.2	7.8	7.1	6.3

Source: GKN historical data, Edison Investment Research estimates

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