Update

26 July 2011

Meggitt

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/09	1,151	234	25.3	8.5	15.6	2.2
12/10	1,162	256	27.8	9.2	14.2	2.3
12/11e	1,403	300	29.6	10.5	13.3	2.7
12/12e	1,594	357	34.6	12.0	11.4	3.0

Note: *PBT and EPS are normalised, excluding intangible amortisation and exceptional items.

Investment summary: US Q2 read-across

With Meggitt's interim results due on 2 August, we feel the prevailing winds are good with the read-across from US Q2 results from the likes of Goodrich and Honeywell hinting that traffic growth and revenues may well beat expectations. Factors such as the high margins derived from aftermarket revenues could contribute to full year upgrade potential. While we will be keeping a keen eye on military and energy revenues, and acknowledge the currency headwind, we see no reason why Meggitt continues to trade at such a substantial discount to its US peers.

US Q2 results highlight strong rebound

Following Q2 earnings releases from Goodrich, Honeywell, GE and B/E Aerospace, all of which referenced greater than expected strength in the commercial aerospace aftermarket, we believe Meggitt's forthcoming interims could provide positive surprises. With commercial aftermarket sales representing about a third of revenues, outperformance here could yield upgrades for the full year. While the weakening dollar will hold back some of this benefit, we feel long-term end market trends are set to benefit the group and support sustained earnings growth.

Interims forecast affected by PSA acquisition funding

We forecast H111 revenues to grow 10% to £603.0m, PBT to be up 7% to £124.6m and EPS up 2% to 12.6p as a result of the January 2011 placing associated with the Pacific Scientific Aerospace (PSA) acquisition (completed April). PSA is set to provide further growth in H2 and give Meggitt electrical systems content on new platforms such as the 787 and A350. We will be looking for signals on the performance of PSA since completion, as well as progress on synergies.

Valuation: Upper end of UK sector, still discount to US

The current rating of 13.3x CY11 EPS, falling to 11.4x CY12 EPS sits at premium of over 20% to the UK A&D sector. With growth set to continue and end markets largely positive, we feel this is warranted. However, we highlight the 20% discount to Goodrich as an indication of the upside potential. Our SOTP fair value is 420p/share.

Price	395.1p
Market Cap	£3,066m

Share price graph

Share details

Code	MGGT
Listing	FULL
Sector	Aerospace & Defence
Shares in issue	776.0m

Price

52 week	High	Low
	397.6p	261.7p

Balance Sheet as at 31 December 2011*

Debt/Equity (%)	61.6
NAV per share (p)	179.5
Net debt (£m)	851.8

** Edison estimates.*

Business

Meggitt is a global manufacturer of aerospace equipment, sensing and defence systems. Its end markets are Civil Aerospace (42%), Military (44%) and Energy & Other (14%).

Valuation

	2010	2011e	2012e
P/E relative	130%	133%	122%
P/CF	8.7x	8.8x	7.5x
EV/Sales	3.0x	2.8x	2.4x
ROE	13%	16%	16%

Geography based on revenues (2010)

UK	Europe	US	Other
10%	23%	54%	13%

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Encouraging read-across from US peers

With comparable Q2 results released in the US over the past week, we feel the general tone has been positive and direct peers have provided evidence that the market dynamics may be more favourable than anticipated.

- Goodrich beat expectations and raised full year guidance. While citing growth in all major market channels, Goodrich upped its expectation for commercial, regional and business jet aftermarket revenue growth to 13% from a previous 7-9% range. During Q&A, management also suggested the double-digit increase could continue into 2012.
- Honeywell marginally beat expectations and raised full year guidance. We highlight the assertion of particularly strong growth in the aerospace commercial aftermarket, with good organic growth anticipated in H2.

H1 forecasts: Acquisition placing and currency headwinds

Our forecasts for H111 are as shown in Exhibit 1 below:

Exhibit 1: Meggitt half year splits (2011 – Edison estimates)

Note: Figures in £m except per share data.

	Revenues			PBT			EPS		
	H1	H2	FY	H1	H2	FY	H1	H2	FY
2010	549.7	612.3	1,162.0	116.2	139.9	256.1	12.3	15.5	27.8
2011e	603.0	800.2	1,403.1	124.6	174.9	299.5	12.6	17.0	29.6

Source: Meggitt, Edison Investment Research

Despite the larger number of shares in issue following the January placing for the PSA acquisition, we believe Meggitt will show revenue, profit and EPS growth. In relation to currency, a ± 5 cent move equates to ± £6m of PBT, generating a c £4m year-on-year H1 headwind at a rate of $1.60/£. We believe, however, that Meggitt's transformation programme will offset much of this.

Positive long-term market trends

We view Meggitt as a well balanced business with high-margin, largely sole-source positions providing protection from delays and perturbations in end markets. Exhibit 2 below highlights the split and Meggitt's five-year growth expectations in each market segment.

Exhibit 2: Meggitt's five-year organic growth expectations

Market	% sales	Drivers	Forecast CAGR
Civil OE	13	Existing platform deliveries remain strong. Growth in new platforms.	7-8%
Civil Aftermarket	29	Expect c 5% ASK growth over period. Recovery in utilisation and higher shipset values on regional and business jets.	8-9%
Military	44	Fighter growth softened by expected JSF delivery delays. Growing installed base will offset reduced utilisation. Growth expected in ground vehicles and training.	c 2%
Energy/ Other	14	Solid growth with new product launches and geographic expansion. High growth in PCHEs with strong recovery in offshore gas demand.	>10%

Source: Meggitt Investor Presentation

With the evidence from US Q2s that the civil aftermarket recovery appears to have accelerated in 2011 ahead of expectations, we would not be surprised to see upgrades in this area, while we expect Military is likely to remain subdued in the short term.

PSA deal provides further upside

With the closure of the PSA deal at the end of April, we also highlight the benefit in terms of future opportunities for Meggitt. The combined business creates a platform from which Meggitt can provide greater electrical systems-based content on existing and future growth programmes where the move from hydraulic to electrical systems is more prevalent. In the short term, the combination also provides Meggitt with a complete solution for fire detection and suppression.

We forecast that PSA will generate revenue of c £30m in H111 and £178m for the full year, with the majority of the benefit of ownership coming through in H2 and on into 2012. Meggitt anticipates achieving $5m of synergies in 2011 and up to $18m by 2014, although, as we have seen both in previous acquisitions and through the transformation programme, management tends to outperform initial targets.

Valuation: Rating discrepancy to closest US peer

The current rating of 13.3x CY11 EPS falling to 11.4x CY12 EPS compares to Meggitt's closest peer, Goodrich, which sits on 16.4x and 14.2x respectively, placing Meggitt at a c 20% discount. We feel that given the close link between the business models and exposures, this discount is excessive, and we value Meggitt on sum-of-the-parts basis as shown in Exhibit 3 below.

Exhibit 3: Meggitt sum-of-the-parts valuation

	2011 NOPAT	P/E	Value (£m)	Basis
Aircraft Braking Systems	92	16.5	1,517	Goodrich
Control Systems	38	16.0	607	Goodrich. Esterline
Polymers & Composites	28	12.7	353	Premium to UK A&D
Sensing Systems	30	16.0	480	Goodrich, Esterline
Equipment Group	80	13.8	1,110	Prem to Cobham, Raytheon, Thales, Babcock
Net debt			(851)	Current forecast
Equity value			3,216	
Shares in issue			765	
Implied fair value per share (p)			420	

Source: Edison Investment Research

As such we feel that, given the positive underlying trends, potential for upgrade momentum and with the full benefit of the PSA deal to come through from 2012 onwards, our 420p fair value could well be revisited post interims on 4 August.

Exhibit 4: Financials

£m	2008	2009	2010	2011e	2012e
Year end 31 December	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	1,163	1,151	1,162	1,403	1,594
Cost of Sales	(638)	(656)	(655)	(786)	(888)
Gross Profit	525	494	507	617	705
EBITDA	341	340	333	400	467
Operating Profit (before amort. and except.)	296	286	304	355	417
Intangible Amortisation	(62)	(69)	(65)	(70)	(75)
Exceptionals	(124)	(53)	(84)	(70)	(75)
Other	0	0	0	0	0
Operating Profit	111	164	155	215	267
Net Interest	(53)	(52)	(48)	(55)	(60)
Profit Before Tax (norm)	243	234	256	300	357
Profit Before Tax (FRS 3)	58	112	108	160	207
Tax	(20)	(42)	(34)	(73)	(90)
Profit After Tax (norm)	175	171	192	226	267
Profit After Tax (FRS 3)	37	70	74	86	117
Average Number of Shares Outstanding (m)	661.9	676.4	691.5	764.9	771.2
EPS - normalised (p)	26.5	25.3	27.8	29.6	34.6
EPS - normalised and fully diluted (p)	26.4	25.3	27.5	29.4	34.5
EPS - (IFRS) (p)	5.6	10.3	10.7	11.3	15.1
Dividend per share (p)	8.5	8.5	9.2	10.5	12.0
Gross Margin (%)	45.1	43.0	43.6	44.0	44.3
EBITDA Margin (%)	29.3	29.6	28.6	28.5	29.3
Operating Margin (before GW and except.) (%)	25.5	24.9	26.1	25.3	26.2
BALANCE SHEET					
Fixed Assets	2,941	2,735	2,765	2,751	2,841
Intangible Assets	2,563	2,310	2,353	2,389	2,429
Tangible Assets	245	216	207	209	206
Investments	133	209	206	153	206
Current Assets	629	515	536	616	696
Stocks	273	237	239	299	359
Debtors	287	211	238	258	278
Cash	67	63	52	52	52
Other	2	5	7	7	7
Current Liabilities	(438)	(337)	(369)	(360)	(367)
Creditors	(423)	(327)	(355)	(347)	(354)
Short term borrowings	(15)	(11)	(14)	(14)	(14)
Long Term Liabilities	(1,846)	(1,639)	(1,495)	(1,625)	(1,515)
Long term borrowings	(1,101)	(861)	(760)	(890)	(780)
Other long term liabilities	(745)	(778)	(735)	(735)	(735)
Net Assets	1,286	1,274	1,438	1,383	1,654
CASH FLOW					
Operating Cash Flow	279	320	316	342	406
Net Interest	(46)	(42)	(38)	(47)	(51)
Tax	(30)	(39)	(26)	(62)	(63)
Capex	(100)	(84)	(89)	(118)	(123)
Acquisitions/disposals	11	(1)	0	(436)	0
Financing	2	1	4	251	0
Dividends	(40)	(30)	(30)	(60)	(60)
Net Cash Flow	75	126	137	(130)	110
Opening net debt/(cash)	815	1,048	809	721	851
HP finance leases initiated	0	0	0	0	0
Other	(308)	113	(50)	0	0
Closing net debt/(cash)	1,048	809	721	851	742

Source: Edison Investment Research, company accounts