# Market Research #006

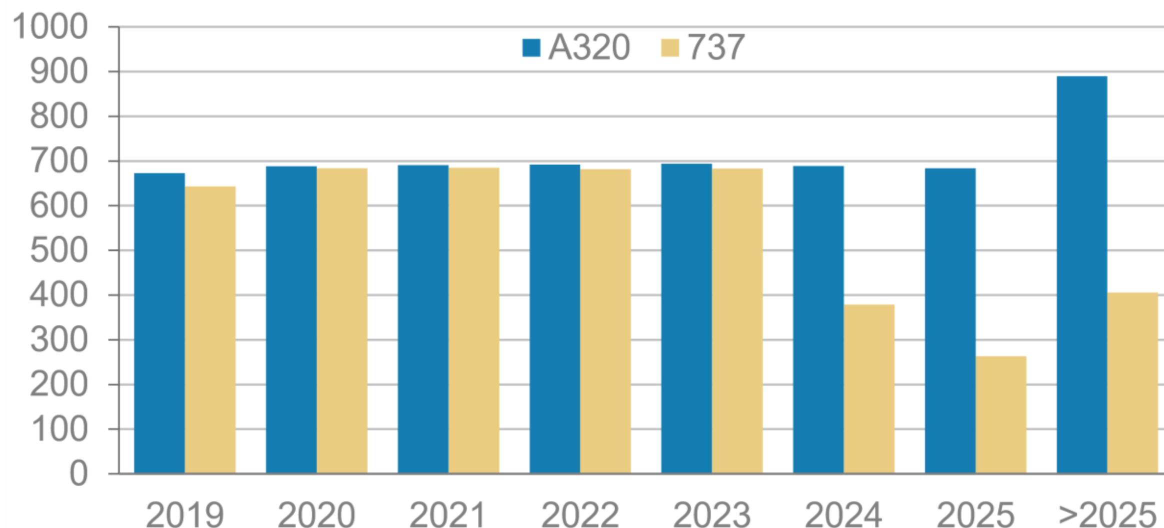
*This is the sixth in a series of Independent research produced by the Murray Wealth Group Research Team. The purpose of this series is to provide insight into our portfolio construction and how our research shapes our investment decisions. We welcome any feedback or questions you may have on these monthly commentaries.*

## Airbus: Big Airplane backlog will drive upside

**Summary: Global airline travel continues to grow, leading to strong demand for new aircraft. Following excellent share price gains for rival Boeing, we think Airbus is best positioned to provide strong capital appreciation.**

We recently purchased shares of Airbus SE, the European aerospace company, based on our view that attractive airline fundamentals, a record backlog and improved manufacturing operations will translate into strong cash flow growth for the company. The company has several opportunities to achieve higher than expected revenue and earnings going forward and we believe the shares could more than double in 4-5 years.

Airbus operates in a virtual duopoly with Boeing in the manufacture of both narrow-body and wide-body aircraft (narrow-body planes have one aisle, wide-body have two). The emergence of the middle class globally has created strong growth in demand for air travel, which naturally requires more planes. New airplanes are also more fuel efficient due to improved engine design and materials technology and this has led to an upgrade cycle amongst carriers that are looking at lowering costs and improving efficiency. As a result, orders for new planes have grown rapidly, creating a nearly 7-year backlog for a new narrow-body plane at current production rates and a 4+ year backlog for widebody planes




*Source: Morgan Stanley*

Given the increased backlog, Airbus is faced with several opportunities in its narrow-body (A320) program. This airframe of the 320 allows for the installation of the higher technology Pratt and Whitney

1100G - geared turbo fan engines, which are a leg up on Boeing. The PW1100g has been plagued by delays to date, but problems appear to be fading. One avenue Airbus will explore to deal with the backlog is raising production from 60 to 70 planes per month. Raising production immediately increases revenue, of course, but also requires additional investment in capacity and produces a strain on a manufacturer's supply chain. The second option is to increase prices, a move that provides higher margins on new sales, but carries a risk of losing orders or encouraging competition (with China being a possible competitor longer term). Airbus' main competitor, Boeing, launched its new 737MAX 2-3 years ahead of Airbus and also has a strong backlog in its narrow-body program. Thus, we can glean some insights from how Boeing has performed. Boeing shares have performed extremely well over the past two years, increasing from ~US$130 per share to ~US$350. Having already increased production in 2018, the company will ramp up its 737 production to 57 planes per month (up 5 planes per month) in 2019.

Additional upside lies in Airbus' push for more services revenue. Service revenue consists of aftermarket product sales and maintenance work. One particular new service, launched in 2017, is Airbus' Skywise data platform. While it is still early days, Airbus is signing up airline partners (most recently Delta Airways), to build a database of Airbus aircraft performance. Airbus is hoping that advanced data analysis techniques will provide new insights into the optimization of operating efficiency. Data programs like these can be very high margin and generate recurring revenue, which could provide upside to the company's valuation.

Regardless of go-forward strategy surrounding its A320 program, Airbus' ongoing cash flow should result in a growing cash hoard. Boeing is also in the midst of its cash flow renaissance, committing to a strong capital return program through dividends and share buybacks, something Airbus' new CEO may consider. As a result, Boeing is valued at over US$200 Billion on trailing 12-month revenue of US$98 Billion while Airbus is valued at $85 Billion on $75 Billion of revenue. This spread represents an opportunity for Airbus shareholders. Note that while Airbus has not historically returned cash to shareholders, rising free cash flow will force management to take a deeper look into how its growing cash balances can be best used to create shareholder value.

Airbus generated €3.68 in free cash flow per share (FCFPS) in 2017. Based on its current share price of €95.31, the company's trailing FCF yield is 3.8%. Analyzing the financial models of two separate investment banks' aerospace analysts, we arrive at potential FCFPS of €10.42 in 2023, three times its 2017 level. This assumes Airbus does not put the cash it generates back to work either through share buybacks or acquisitions. With the additional benefit from putting this cash to work, it is possible that its FCFPS could be closer to €15 in 2023, which would represent a FCF yield of over 15% at current prices. A reasonable target valuation for the FCF yield is around 6%-7%, which implies a more than doubling of Airbus' stock price over the next 4-5 years.

We believe Airbus has the strong backlog and program to weather any economic storm and continue to grow its cash flow. Its new management team is no doubt evaluating how to best use its cash hoard, but we believe there are many paths to create value for shareholders.