Spirit AeroSys-A

The 737 story gets more complicated – reiterate Underperform and cut PO to $25

Reiterate Rating: UNDERPERFORM | PO: 25.00 USD | Price: 25.92 USD

30 May 2023

Equity

Hard path to 7-9% cash margins, BofA sees 5%

Despite strong results in defense and aftermarket, we continue to see Spirit AeroSystems (ticker: SPR) as a 737 story. While looming 737 production ramp is expected to unlock significant operational improvements, the recent issues with non-conforming vertical fin attach-fittings since 2019 shows important performance issues at current rates. We expect SPR to be able to generate FCF at 5% of sales by mid-2020s, short of 7-9% conversion target. FCF margins are further pressured by ongoing labor negotiations, overly optimistic turnaround in cash losing programs, and continued challenges in the supply chain. We reiterate our Underperform and lower our PO to $25.

MAX vertical fin attach-fittings non-conforming since '19

In mid-April, Boeing announced Spirit found an issue with two of the eight fittings that attach the vertical tail to the rear end of the aft fuselage. Most of the 737 MAX-7/-8/-8200 and P-8 aircraft produced since 2019 are affected. On top of repairs to Wichita inventories and factory disruption costs, we estimate SPR will have to absorb the excess shipsets and raw materials from its suppliers. We expect the company to burn ~$200mn in FCF in 2Q23 and $150mn in 2023e.

SPR will receive $280mn of cash advances to help support SPR near-term liquidity. The recognized costs don't include additional costs, incl. repairing previously delivered units and warranty costs related to units in service. The timing of the expiration of the labor agreements vs. Boeing pricing agreements should put more pressure on SPR cash margins in the near term.

Skeptical on steep improvement for unprofitable programs

In 1Q23, SPR recorded an $110mn in forward loss charges. Spirit currently has $682mn in forward loss provision balance, expected to be burned by May 2026. We remain skeptical on both a) SPR's ability to close more beneficial pricing agreements given the challenging operational performance and b) its ability to drive costs down as aggressively as implied in the forward loss balance. See details inside.

Estimates (Dec) (US$)	2021A	2022A	2023E	2024E	2025E
EPS	(3.50)	(2.79)	(0.49)	2.10	3.45
GAAP EPS	(5.19)	(5.22)	(2.39)	2.10	3.45
EPS Change (YoY)	38.8%	20.3%	82.4%	NM	64.3%
Consensus EPS (Bloomberg)			(1.71)	1.48	3.61
DPS	0.04	0.03	0	0	0
Valuation (Dec)					
P/E	NM	NM	NM	12.3x	7.5x
GAAP P/E	NM	NM	NM	12.3x	7.5x
Dividend Yield	0.2%	0.1%	0%	0%	0%
EV / EBITDA*	NM	90.5x	13.0x	6.9x	5.9x
Free Cash Flow Yield*	-7.8%	-18.9%	-5.5%	3.3%	10.8%

* For full definitions of *iQmethod* SM measures, see page 7.

Key Changes

(US$)	Previous	Current
Price Obj.	26.00	25.00
2023E Rev (m)	6,447.9	6,602.4
2024E Rev (m)	7,456.9	7,887.9
2025E Rev (m)	8,358.8	8,771.0
2023E EPS	1.05	-0.49
2024E EPS	2.30	2.10
2025E EPS	3.80	3.45

Ronald J. Epstein
Research Analyst
BofAS
+1 646 855 5695
r.epstein@bofa.com

Mariana Perez Mora >>
Research Analyst
Merrill Lynch (Argentina)
+1 646 855 5696
mariana.perezmora@bofa.com

Elizabeth Grenfell
Research Analyst
BofAS
+1 646 855 0156
elizabeth.grenfell2@bofa.com

Andre Madrid
Research Analyst
BofAS
+1 646 725 3107
andre.madrid@bofa.com

Jordan Lyonnais
Research Analyst
BofAS
+1 646 855 5204
jordan.lyonnais@bofa.com

Samantha Stiroh
Research Analyst
BofAS
+1 646 855 5725
samantha.stiroh@bofa.com

Stock Data

Price	25.92 USD
Price Objective	25.00 USD
Date Established	30-May-2023
Investment Opinion	C-3-9
52-Week Range	21.14 USD - 38.55 USD
Mrkt Val (mn) / Shares Out (mn)	2,727 USD / 105.2
Average Daily Value (mn)	82.37 USD
BofA Ticker / Exchange	SPR / NYS
Bloomberg / Reuters	SPR US / SPR.N
ROE (2023E)	NA
Net Dbt to Eqty (Dec-2022A)	NA
ESGMeter™	High

ESGMeter is not indicative of a company's future stock price performance and is not an investment recommendation or rating. ESGMeter is independent of BofA Global Research's equity investment rating, volatility risk rating, income rating, and price objective for that company. For full details, refer to "BofA ESGMeter Methodology".

Refer to important disclosures on page 8 to 10. Analyst Certification on page 6. Price Objective Basis/Risk on page 6.
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Timestamp: 30 May 2023 03:00AM EDT

iQprofile SM Spirit AeroSys-A

iQmethod SM – Bus Performance*

(US$ Millions)	2021A	2022A	2023E	2024E	2025E
Return on Capital Employed	-6.4%	-4.7%	2.7%	9.7%	12.8%
Return on Equity	-55.9%	-284.8%	NM	NM	NM
Operating Margin	-11.6%	-5.6%	2.1%	7.3%	8.5%
Free Cash Flow	(214)	(516)	(150)	90	295

iQmethod SM – Quality of Earnings*

(US$ Millions)	2021A	2022A	2023E	2024E	2025E
Cash Realization Ratio	NM	NM	NM	1.1x	1.3x
Asset Replacement Ratio	0.4x	0.3x	0.4x	0.5x	0.6x
Tax Rate	3.1%	NM	5.9%	21.0%	21.0%
Net Debt-to-Equity Ratio	NM	NM	NM	NM	NM
Interest Cover	-1.9x	-1.2x	0.5x	2.0x	2.6x

Income Statement Data (Dec)

(US$ Millions)	2021A	2022A	2023E	2024E	2025E
Sales	3,953	5,030	6,602	7,888	8,771
% Change	16.1%	27.2%	31.3%	19.5%	11.2%
Gross Profit	(118)	49	483	900	1,080
% Change	73.3%	NM	892.8%	86.4%	20.0%
EBITDA	(117)	68	472	894	1,043
% Change	77.4%	NM	596.5%	89.3%	16.6%
Net Interest & Other Income	(96)	(258)	(407)	(294)	(283)
Net Income (Adjusted)	**(365)**	**(292)**	**(51)**	**221**	**365**
% Change	**38.6%**	**20.0%**	**82.5%**	**NM**	**65.2%**

Free Cash Flow Data (Dec)

(US$ Millions)	2021A	2022A	2023E	2024E	2025E
Net Income from Cont Operations (GAAP)	(538)	(545)	(251)	221	365
Depreciation & Amortization	343	349	332	319	298
Change in Working Capital	403	(142)	70	(131)	(44)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	(270)	(57)	(176)	(169)	(148)
Capital Expenditure	(151)	(122)	(125)	(150)	(175)
Free Cash Flow	**-214**	**-516**	**-150**	**90**	**295**
% Change	**75.2%**	**-141.4%**	**70.9%**	**NM**	**226.4%**

Balance Sheet Data (Dec)

(US$ Millions)	2021A	2022A	2023E	2024E	2025E
Cash & Equivalents	1,479	659	766	667	522
Trade Receivables	462	490	651	692	721
Other Current Assets	1,866	2,010	2,160	2,299	2,335
Property, Plant & Equipment	2,386	2,206	2,024	1,866	1,756
Other Non-Current Assets	1,546	1,302	1,116	1,104	1,092
Total Assets	**7,737**	**6,666**	**6,717**	**6,627**	**6,427**
Short-Term Debt	50	54	55	55	55
Other Current Liabilities	1,827	1,899	1,985	1,996	1,885
Long-Term Debt	3,743	3,815	4,096	3,906	3,466
Other Non-Current Liabilities	1,670	1,143	995	864	849
Total Liabilities	**7,289**	**6,910**	**7,131**	**6,821**	**6,255**
Total Equity	**449**	**(244)**	**(415)**	**(193)**	**172**
Total Equity & Liabilities	**7,737**	**6,666**	**6,717**	**6,627**	**6,427**

* For full definitions of *iQmethod* SM measures, see page 7.

Company Sector

Aerospace

Company Description

Spirit AeroSystems Holdings, Inc. (SPR) is the largest independent original parts designer and manufacturer of aerostructures in the world. Spirit was formed as result of Onex Partners purchasing Boeing Wichita (June 2005) and BAE Aerostructures (April 2006). The company's segments include Fuselage Systems, Propulsion Systems, and Wing Systems. Boeing and Airbus S.A.S are the major contributors to the revenues of the company.

Investment Rationale

SPR is the largest independent manufacturer in aerostructures. While we appreciate the company's efforts to diversify away from Boeing, the FCF turnaround story is still mostly dependent on OE volumes (mostly 737) and turning some unprofitable programs around (787, A350, A220). We think SPR will be able to generate 5% of sales in FCF by mid-2020s, below the company's target for 7-9%.

Stock Data

Average Daily Volume	3,177,942

Quarterly Earnings Estimates

	2022	2023
Q1	0.03A	-1.69A
Q2	-1.21A	-0.68E
Q3	-0.15A	0.28E
Q4	-1.46A	0.68E

MAX vertical fin attach-fittings non-conforming since '19

In mid-April, Boeing announced Spirit found an issue with two of the eight fittings that attach the vertical tail to the rear end of the aft fuselage. Most of the 737 MAX-7/-8/-8200 and P-8 aircraft produced since 2019 are affected. Boeing has identified 75% of its MAX inventories have to be fixed and Spirit mentioned about two thirds of the inventories available for shipping are impacted and about 60% of the total units in Wichita.

Boeing and the FAA have determined that these "FAA non-conforming" fittings do not imply an "immediate" safety of flight issue. However, this issue is impacting a significant portion of the deliveries taken place post-MAX crashes grounding. To put this into perspective, almost 690 737-8 MAXs currently in-service or parked have been built since 2019. Spirit's management mentioned they estimate 500 in-service aircraft will have to be inspected.

Repair work cost estimates only for inventory in Wichita

As of early May, SPR had already revised the assembly process and production, restarted production and resumed shipments of conforming fuselages to Boeing. SPR had completed repair on 4 units. Management expects the repair work on the 35-40 units in Wichita to be complete by the end of July.

Total impact to gross profit from the repairs and factory disruption is expected to be $31mn ($17mn booked in 1Q23). This impact includes a) the repairs to Wichita inventories, which are expected to cost $100-150k per unit, implying a $5mn total cost, and b) a $7mn cumulative catch-up charge related to the impact to average production costs for prior deliveries.

$280mn advances to help offset $150mn FCF burn

On top of the gross margins impact, we estimate SPR will have to absorb the cash headwinds of continuing to take shipsets and raw materials from its suppliers. The rework will impact 2Q23 737 deliveries, but SPR is still targeting production rate increases to 38/month in August and 42/month in October. We expect the company to burn ~$200mn in FCF in 2Q23 and $150mn in 2023e (at the higher end of management expectations). SPR will receive $280mn of cash advances to help support SPR near-term liquidity, including $180mn from Boeing, not included in FCF estimates. We note FCF could also benefit from further sale of accounts receivable balances. For example, in 1Q23, SPR sold $849.4mn of accounts receivable ($2.9bn in 2022).

The recognized costs, however, don't include additional costs, including repairing previously delivered units and warranty costs related to the affected 737 units in service, that cannot be reasonably estimated at this time. We estimate a cost of at least $125mn to fix almost 500 aircraft. We incorporate these excess costs as a 50bps headwind to commercial margins on profitable programs.

We are lowering our adjusted EPS estimates to ($1.40) from $1.05 in 2023e, to $2.10 from $2.30 in 2024e, and to $3.45 from $3.80 in 2025e.

IAM negotiations could further pressure margins

The International Association of Machinists and Aerospace Workers (IAM) contract covers 57% of SPR US employees. IAM is covered by two major agreements, and the one that expires June 2023 covers ~55% of US employees. The other one expires in November 2027 and covers a small percentage of employees. The main table negotiation started on May 1st.

The timing of the expiration of the labor agreements vs. Boeing pricing agreements (expiring in the early 2030s for 737, 767, 777 and through unit 2,205 for 787) puts more pressure on SPR cash margins in the near term. We continue to think that mid-2020s operating and cash margin targets are incrementally harder to achieve (both impacted by pricing/costs balance and slower than expected production ramps).

Supply chain issues to continue, labor trending better

The health of SPR's supply chain remains challenging. The company continues to encounter shortages and one-off supplier issues that it is addressing as they arise. Spirit has 75-80 people working with the most distressed suppliers, helping them fix their plans, buy materials, and conduct other tasks. Management expects continued supply chain challenges throughout the year, with some gradual improvement going into next year. On the labor front, SPR is enthusiastic about the progress in hiring and training new employees ahead of the planned 737 production rate increases.

Skeptical on steep improvement for unprofitable programs

In 1Q23, SPR recorded an $81mn forward loss on the A220 program: $46mn was a non-recurring cost related to a distressed supplier and $35mn was driven by production schedule and FX changes.

The remaining $29mn of forward losses were mainly related to the A350 program ($18mn on production schedule changes) and the 787 program ($8mn on increased labor and supply chain). SPR also recognized unfavorable cumulative catch-up adjustments of $12mn ($7mn of those related to the vertical fin attach fitting issue).

Spirit currently has $682mn in its forward loss provision balance, expected to be burned by May 2026. However, we note these estimates imply, not only that renewed price agreements will turn the programs profitable, but also an overly optimistic improvement in loss per delivered aircraft. 1Q23 forward loss reduction (excluding the add ups and netting for the one-off $46mn supplier related charge) implied a $2.3mn cost per unprofitable delivered plane (787, A220, A350). This compares to an implied cost per plane of $1.6mn on the short term forward loss balance and only $0.6mn loss per plane through early 2026.

We remain skeptical on both a) SPR's ability to close more beneficial pricing agreements given the challenging operational performance and b) its ability to drive costs down that aggressively. SPR contingency related to a potential delayed production ramp on these programs continues to be capped at $220mn. This compares to our estimate of around $350mn.

Defense & Aftermarket trading well

The Defense and Aftermarket businesses continue to show strong topline expansion. Defense and Space sales were up 19% in 1Q23 and SPR should continue to benefit from defense opportunities, including the recently awarded FLRAA contract to the V-280 team and a recent agreement with Skyworks to pursue vertical takeoff and landing high speed and long-range aircraft in the UK and European markets. The initial development phase is usually cost plus, however, some contracts turn into fixed price agreements for the low rate initial production (LRIP) phase. We remain cautious on the margins for any already agreed upon LRIP contract, considering Northrop Grumman commentary around B-21 LRIP potential losses as its agreement was signed several years ago and does not factor in the current inflationary environment.

Aftermarket sales were up 22% in 1Q23 and is expected to benefit from continued airtraffic recovery and new agreements, including a) the cooperation agreement with Singapore's ST Engineering's commercial aerospace business to support customers in the Middle East with aircraft engine nacelle in MRO solutions and b) agreements with both Joramco in Jordan and GMR technique in India to be Spirits' authorized repair centers.

Lowering PO to $25

We are lowering our PO to $25 from $26 as lower than previously expected cash profitability is partially offset by YTD market appreciation. Our PO of $25 is based on 2025e FCF of $2.8/share (vs. prior $3.2/share) and relative discount to the S&P500 of 0.5x (unchanged). This equals to a 9x P/FCF (vs. prior 8x). In our view, a relative multiple in line with the lower end of the historical range fairly reflects the looming aerospace recovery as well as the significant risks ahead and lack of a regular dividend.

Price objective basis & risk

Spirit AeroSys-A (SPR)

Our PO of $25 is based on 2025e FCF of $2.8/share and relative discount to the S&P500 of 0.5x. This equals to a 9x P/FCF. In our view, a relative multiple in line with the lower end of the historical range fairly reflects the looming aerospace recovery as well as the significant risks ahead and lack of a regular dividend.

Downside risks: Revenues are heavily dependent on Boeing (more than 2/3rds of sales). A material change in the cycle or conditions at Boeing could negatively impact Spirit. SPR is involved with several aircraft development programs that could suffer from cost overruns or other development-related risks. The majority of sales are OEM, and there is little aftermarket, which could prove problematic if the civil aircraft cycle turns dramatically. Higher oil prices would likely derail air traffic growth and, therefore, aircraft demand, resulting in a downturn in commercial aviation. Given that aircraft are priced in dollars, an unexpected rapid appreciation in the dollar could significantly impact order activity. There could be additional forward losses if ongoing pricing negotiations are unfavorable.

Upside risks to our PO could be better-than-expected volumes and cash margins at 737, increases in shipset content on Airbus programs, favorable price negotiations on cash losing programs (including 787, A350, A220), higher than expected growth at aftermarket and/or defense end-markets.

Analyst Certification

I, Ronald J. Epstein, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

US - Aerospace and Defense Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
BUY				
	AerCap Holdings N.V.	AER	AER US	Ronald J. Epstein
	Air Lease Corporation	AL	AL US	Ronald J. Epstein
	BWX Technologies, Inc.	BWXT	BWXT US	Ronald J. Epstein
	CACI International	CACI	CACI US	Mariana Perez Mora
	Cadre Holdings Inc	CDRE	CDRE US	Ronald J. Epstein
	Crane Co.	CR	CR US	Ronald J. Epstein
	Embraer	ERJ	ERJ US	Ronald J. Epstein
	General Dynamics	GD	GD US	Ronald J. Epstein
	Howmet Aerospace Inc.	HWM	HWM US	Ronald J. Epstein
	KBR	KBR	KBR US	Mariana Perez Mora
	Leidos Holdings	LDOS	LDOS US	Mariana Perez Mora
	Northrop Grumman	NOC	NOC US	Ronald J. Epstein
	Palantir Technologies	PLTR	PLTR US	Mariana Perez Mora
	Raytheon Tech	RTX	RTX US	Ronald J. Epstein
	Rocket Lab	RKLB	RKLB US	Ronald J. Epstein
	Teledyne Technologies Inc	TDY	TDY US	Ronald J. Epstein
	TransDigm Group Inc.	TDG	TDG US	Ronald J. Epstein
	Triumph Group	TGI	TGI US	Ronald J. Epstein
NEUTRAL				
	Albany International	AIN	AIN US	Ronald J. Epstein
	Boeing	BA	BA US	Ronald J. Epstein
	Booz Allen Hamilton	BAH	BAH US	Ronald J. Epstein
	CAE Inc.	YCAE	CAE CN	Ronald J. Epstein
	CAE Inc.	CAE	CAE US	Ronald J. Epstein
	Garmin	GRMN	GRMN US	Ronald J. Epstein
	HEICO Corporation	HEI	HEI US	Ronald J. Epstein

US - Aerospace and Defense Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
	Hexcel Corporation	HXL	HXL US	Ronald J. Epstein
	L3Harris	LHX	LHX US	Ronald J. Epstein
	Lockheed Martin	LMT	LMT US	Ronald J. Epstein
	Textron	TXT	TXT US	Ronald J. Epstein
UNDERPERFORM				
	Astra Space Inc.	ASTR	ASTR US	Ronald J. Epstein
	Bombardier	BDRBF	BDRBF US	Ronald J. Epstein
	Bombardier Inc.	YBBD B	BBD/B CN	Ronald J. Epstein
	Huntington Ingalls Industries	HII	HII US	Ronald J. Epstein
	Parsons Corporation	PSN	PSN US	Mariana Perez Mora
	RBC Bearings Inc	RBC	RBC US	Ronald J. Epstein
	Spire Global inc	SPIR	SPIR US	Ronald J. Epstein
	Spirit AeroSys-A	SPR	SPR US	Ronald J. Epstein
	Terran Orbital Corporation	LLAP	LLAP US	Ronald J. Epstein
	Virgin Galactic Holdings	SPCE	SPCE US	Ronald J. Epstein

*iQ*method SM Measures Definitions

Business Performance	**Numerator**	**Denominator**
Return On Capital Employed	NOPAT = (EBIT + Interest Income) × (1 – Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5 Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings	**Numerator**	**Denominator**
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt – Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit	**Numerator**	**Denominator**
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap = Current Share Price × Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price × Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

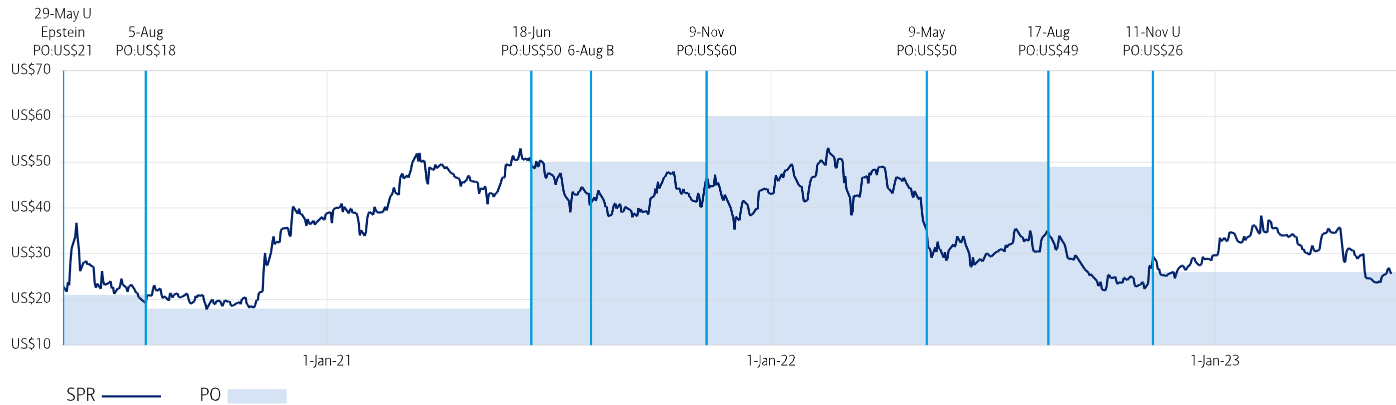
iQmethod SM is the set of BofA Global Research standard measures that serve to maintain global consistency under three broad headings: Business Performance, Quality of Earnings, and validations. The key features of iQmethod are: A consistently structured, detailed, and transparent methodology. Guidelines to maximize the effectiveness of the comparative valuation process, and to identify some common pitfalls.

iQdatabase ® is our real-time global research database that is sourced directly from our equity analysts' earnings models and includes forecasted as well as historical data for income statements, balance sheets, and cash flow statements for companies covered by BofA Global Research.

Disclosures

Important Disclosures

Spirit AeroSys-A (SPR) Price Chart



B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of a date no more than one trading day prior to the date of the report.

Equity Investment Rating Distribution: Aerospace/Defense Electronics Group (as of 31 Mar 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships R1	Count	Percent
Buy	25	51.02%	Buy	18	72.00%
Hold	14	28.57%	Hold	13	92.86%
Sell	10	20.41%	Sell	4	40.00%

Equity Investment Rating Distribution: Global Group (as of 31 Mar 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships R1	Count	Percent
Buy	1869	53.01%	Buy	1030	55.11%
Hold	827	23.45%	Hold	476	57.56%
Sell	830	23.54%	Sell	389	46.87%

[R1] Issuers that were investment banking clients of BofA Securities or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster[R2]
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

[R2] Ratings dispersions may vary from time to time where BofA Global Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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