

Aerospace & Defence Update

Global Industrials Conference 2024 –
Aerospace & Defence preview

Industry Overview

Global Industrials Conference – 19th – 21st March 2024

On 19 – 21 March we will host our annual Global Industrial Conference in London, hosting c.75 corporates and >660 investors over 3 days. From our coverage universe, we welcome Airbus, BAE Systems, Dassault Aviation, Hensoldt, Kongsberg, Leonardo, Montana Aerospace, MTU Aero, Rheinmetall, Rolls Royce, SAAB and Safran. In this note we highlight key themes to watch across our defence and aerospace coverage & key questions for each company attending the conference.

Theme 1: Supply chain improving but seeing challenges

Airbus deliveries have continued their momentum in the last few months, but there are still supply chain challenges. Dassault highlighted structures challenges at their FY23 results last week. Boeing has confirmed they are in talks with Spirit to acquire them as part of the groups move to improve quality in the supply chain, and Melrose talked of supply chain bottle necks in their Engines business, linked to forging and casting. In reality we think challenges will remain through 2024, but not materially disrupting the production outlook for Airbus. We remain of the view it is becoming more manageable.

Theme 2: Cash returns as civil becomes a cash machine

Last week GE presented their 2024 Aerospace capital markets day, part of which was commentary around cash flow (100% FCF conversion mid-term) and capital return (GE announced a \$15bn buyback over three years). We see cash conversion across the civil aerospace names averaging 100% over the next 5 years, and with sector leverage under control, we expect cash returns to remain a key driver of differentiation mid-term, across both M&A, as well as shareholder returns. We expect this to be a key focus of questions from investors for the civil aerospace companies.

Theme 3: Defence order momentum remains strong

Order momentum has been strong in FY23 across our coverage. SAAB saw order intake up 23% YoY, with B2B doubling during the year in areas like Ground Combat. Kongsberg's Q4 order intake was up 16% YoY, while Dassault is still benefitting from strong momentum from Rafale (e.g. Indonesia, India). We believe the ongoing demand environment remains strong across all key geographies, and we expect to hear more from the companies attending around how FY24 has been developing so far.

Theme 4: Strong cash in Defence facilitates cap allocation

BAE Systems, Thales and Dassault have all been buying back in 2H23. We think consistent capital allocation, with excess capital returned through buybacks is going to be rewarded in valuations in FY24. Given FY23 commentary from most the companies in our coverage around bolt-on M&A ambitions and solid capital allocation, we expect to hear more around each company's strategy in terms of cash deployment.

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Airbus – Key questions

We will host Airbus CFO at the conference. Below are 10 key questions:

1. **FAL investment** - You are investing heavily in the final assembly lines for the A320/A321, making them flexible, modernising them and you will have 10 FALs operational by 2026 - what is this investment going to do for the cost base and performance of the programme?
2. **Mid-term ramp** - You have guided for 800 deliveries, 65 incremental planes YoY – which is down vs. last year. Is this not a bit disappointing? How should we be thinking about the step up in production 2025-27?
3. **Engines** - You highlighted on the call no change on the situation with the GTF for 2024, but how about 2025? Do you have a purchase order agreement with Pratt for next year now and does it support the growth next year?
4. **Supply chain** – Can you give us some colour on how you are thinking of supply chain in FY24? What are the big bottlenecks as you see them today? What is the main risk in terms of supply chain in 2024?
5. **Labour** - You hired >13k people in 2023. Now at 148k people in the group, what is the rough mid-term objective for the group?
6. **Widebody** - demand in this market has seen a strong inflection, with a very strong book to bill in 2023 driven by A350 - You are going to 10/mnth, is there potential to go higher than this later in the decade?
7. **Narrowbody** – The A321XLR is to be delivered this year. Where do you see the rough production rate of this mid-term? You have a strong market position on NB, is there a case to go higher than 75/mnth at some point? Or is staying at 75/mnth and building out the late 2020/early 2030 backlog the focus?
8. **A220** - how are you seeing the production ramp to 14/mnth? Is this on track? How negative was the A220 contribution in 2023? When do you see this program at breakeven?
9. **Defence & Security** - The business clearly had a lot of challenges in 2022 and 2023. How should we think about the mid-term trajectory of this business? How quickly can we get back to high single digit margins?
10. **Balance sheet** - As the new CFO, how do you feel about the strength of the Airbus balance sheet. Many see it as extremely conservative. Do you still feel €10bn net cash is the right amount to run the business?

BAE Systems – Key questions

We are hosting BAE Systems CFO. Below are 10 key questions:

1. **Growth outlook** - You guided for 5-7% organic growth in 2024. Can you talk about the drivers of that growth & visibility around that? Peers have talked about 5 year period of visibility for growth, could this be the same for BAE? You gave a backlog and pipeline figure of £250bn at the results. Are there still opportunities to grow this number?
2. **Margin outlook** - You have guided for margin expansion organically in 2024. What are the divisions that will drive margin expansion the most through 2024? Mid-term, what are the divisions where you see the highest upside on margins?
3. **Ball Aerospace** - You have just closed and completed the Ball Aero deal. Can you talk about why the company excites you, what it does and where it fits in with the US defence strategy. You have talked about double digit growth in this business, what the level of visibility you have around this? Is this a business that you could further supplement with M&A?
4. **Inorganic growth/M&A** - You are still sitting on a strong balance sheet position. What is the BAE strategy around M&A? Is there anything missing in the portfolio? Have the priorities of the group from an M&A perspective changed at all in the last 24 months post the Ukraine invasion?
5. **Cash Generation** - Cash generation has improved strongly over the past 6-7 years - How much of this has been benefitting from improving orders vs. better business management on cash? Are there any areas in the portfolio today that are weighing on cash generation?
6. **CapEx** - On the 4Q conference call you guided for higher capex vs 2023. Could you provide some additional colour on this? Where is this CapEx going? How should we think about the mid-term outlook for CapEx/D&A? Is there a significant amount of growth CapEx needed from 2024 onwards?
7. **US Defence budget outlook** - The US is 42% of the group, can you give us an update on the budget outlook here and your key areas of exposure.
8. **AUKUS** - The AUKUS strategic pact. Could you remind us what the key political objectives of the pact are and why it's important? What could this mean for BAE mid-term? Australia announced a new ship building strategy a few weeks ago, can you remind us what this means for BAE?
9. **Global Combat Air** - Where are we on this programme?? Can you talk us through the timeline of this project with Japan and Italy?
10. **Capital allocation & buybacks** - You assume £500mn of buybacks in the 2024 guide, what else should we expect when it comes to capital allocation? What do you feel is a comfortable leverage level for the group?

Dassault Aviation – Key questions

We are hosting Dassault's Head of IR. Below are 10 key questions:

- 1 **Rafale exports.** Rafale export momentum has been very strong across FY23. Can you give us any more colour on what to expect next? How are your export campaigns progressing?
- 2 **Down-payments:** How should we think about the phasing of down-payments in FY24? Anything worth keeping in mind from a cash perspective?
- 3 **Rafale production rate:** How are you thinking about production rates medium term? What is a sustainable rate? How are you thinking about ramping up capacity?
- 4 **French Rafale:** We have seen an order for 42 Rafale from France in FY23. What sort of additional opportunities do you see on this front? How does the Military Programming Law affect you? How shall we think about F5 in FY24?
- 5 **Supply chain:** Can you give us more colour on how you are seeing supply chain at the moment? What sort of visibility do you have at the moment? What are the key pressures?
- 6 **Falcon:** Orders were relatively weak in FY23 given the late certification of the Falcon 6X. How should we think about order intake for this year? Anything we should keep in mind?
- 7 **Falcon 10x:** Can you give us more colour on how the programme is progressing? You have mentioned in the past that the Entry Into Service has been pushed to 2027 - is this still the case? How are things progressing on this programme?
- 8 **Business jets market:** Could you give us more colour on how you expect the business jet market to develop this year? Any difference between North America and Europe? What have you seen so far?
- 9 **FCAS:** How is the international cooperation on FCAS progressing? Where are we now with the programme?
- 10 **Available cash.** Available cash was very strong in FY22 at €9.5bn and you have completed a buyback programme in 2023 for c.EUR700m - How should we think about cash deployment/shareholder returns going forwards? Is it fair to assume the same approach to buybacks in 2024?

Hensoldt – Key Questions

We are hosting Hensoldt's CFO. Below are 10 key questions:

1. **Growth Outlook:** You are guiding for c.10% mid-term but your 2024 organic guidance implies >8% growth? When do you expect growth to accelerate to 10%?
- Optronics growth was a bit weak in 2023. How should we think about the growth recovery in Optronics in 2024?
2. **Profitability outlook:** How should we think about profitability? Why does your mid-term guidance (before pass through revenues) imply limited margin expansion vs 2023?
3. **Book to bill:** How should we think about B2B ratio in 2024E? Should we expect an acceleration of orders vs 2023 as the Special German defence fund starts to flow through materially?
4. **Backlog and revenue visibility:** Could you update us on the main orders that you expect for 2024? On your last CMD you mentioned that around 85% of your 2024 revenues are covered. Could you update us on this? How is 2025 progressing?
5. **Main programs:** Can you please update us on the current state of your main programs?
6. **FCF outlook:** You changed your guidance around FCF conversion in Q4. What are the main drivers that you have to improve cash conversion mid-term?
7. **ESG:** Can you remind us what ESG does, and why it's important for the business?
8. **Inorganic growth:** How should we think about M&A mid-term? What kind of assets would you be willing to consider?
9. **Supply chain and labour:** How are you doing in terms of supply chain and labour shortages? Why did you struggle to ramp up production in Optronics in 2023? Where was the main bottleneck?
10. **Leonardo stake:** Can you remind us on your relationship with Leonardo? Is still seen as an strategic relationship? What are the main programs in which you cooperate?

Kongsberg – Key questions

We are hosting Kongsberg's CFO. Below are 10 key questions:

- 1 **Defence order momentum** has been strong so far: what has been the big driver of this? How should we think about medium term?
- 2 **Kongsberg Defence (KDA) Backlog:** How are you thinking about B2B into 2024? What is your current visibility with the backlog? What % of this is missiles currently?
- 3 **Defence budgets:** How big of a customer are NATO members for Kongsberg? How are you currently seeing demand on this front?
- 4 **KDA margins:** How should we think about margins for FY24 given what you have highlighted in the past about margin compression?
- 5 **Discovery:** Can you help us to understand what is the real earnings power of Sensors & Electronics? How has the business been progressing since you have separated it from KM? Can you remind us why you decided to separate this from Maritime?
- 6 **KM mid-term opportunities:** What are the main growth levers that you see at KM? How should we think about new build & aftermarket activities in 2025-2026?
- 7 **KDA mid-term opportunities:** What are the main growth levers that you see at KDA? How should we think about demand beyond 2024? What are the key programmes/projects in the pipeline?
- 8 **Macro weighing on Kongsberg Maritime (KM):** How is KM performing YTD and what should we expect on the OE side in FY24? How is aftermarket? How much visibility do you have in this business?
- 9 **Margins:** Defence margins are expected to decrease due to unfavourable mix (higher exposure to missiles) as mentioned earlier - how much can Maritime mitigate these headwinds?
- 10 **Cash:** How should we think about cash in FY24? How should we think about NWC and Capex? Key elements to keep in mind? How do we think about cash mid-term?

Leonardo – Key Questions

We are hosting Leonardo's CEO. Below are 10 key questions:

1. **JVs:** At the Investor Day you provided a strategic update: How should we think about the future of the JVs? Particularly MBDA and the space Jvs? How are you thinking about Thales Alenia Space and Telespazio and the ownership structure of these JVs?
2. **Hensoldt:** Can you give us an update on your thoughts re. your stake in Hensoldt? What is the medium-term strategy here?
3. **DRS:** We've seen you reduce the stake in DRS. Can you give us more colour on how you're thinking about the business? Is it fair to assume you're going to continue along these lines? Do you plan to remain >50% ownership?
4. **Mid-term targets:** Can you expand a bit more on our mid-term targets for EBITA margins and FOCF, and how we do we get there?
5. **Margins:** You have talked about being able to improve profitability. Focusing on margins for FY23 and onwards. Can you give us more colour around the major drivers of margins for FY23? How should we see the different divisions progressing in FY24?
6. **FOCF:** Free cash flow improvement has been significant YoY, and you have mentioned you think there is even more to be done. Can you help us understand the main dynamics moving free cash flow next year? How should we think about cash deployment mid-term?
7. **Orders:** You had a 1.17x B2B in FY23. How should we think about momentum going into FY24 and onwards? Where do you see the biggest growth opportunities?
8. **Helicopters:** Helicopters benefitted from strong order momentum in FY23 and we have seen some strong orders coming in in 2024 already - How is the business progressing? How do you see civil vs military developing this year? Where do you see the biggest opportunities for growth and margin expansion?
9. **Aerostructures:** You have mentioned in the past that you might be renegotiating your contracts - any update in this?
10. **Balance sheet/deleveraging:** you have mentioned that deleveraging is one of the key priorities for this year. Can you walk us through what will be the key moving pieces to achieve this?

Montana Aerospace – Key questions

We are hosting Montana's CFO. Below are 10 key questions:

- 1 **Growth** – How should we think about revenue growth at group level? Organic vs inorganic? Will Aerospace still be the main driver?
- 2 **Aerospace margins** - You have an ambitious target of >30% for the long term, however margins so far have been weak. Do the mid-term target still stand? How should we think about margin expansion going forwards?
- 3 **Supply chain** - How are you managing supply chain constraints at the moment? What are the key challenges?
- 4 **Energy costs:** You have mentioned in the past higher energy costs, how are you dealing with this now? How much of these can you pass through?
- 5 **Energy:** your energy business has expanded significantly over the last year, and you have mentioned in the past you are potentially thinking of listing it – is this still the case? How should we think about the business?
- 6 **E-Mobility** – How do you see e-mobility expanding? What's the key driver of growth and margin expansion? How is recycling going?
- 7 **FY24 outlook:** How should we think about FY24? Are you still assuming more conservative production rates than what Airbus and Boeing have been guiding for? How should we think about margins and cash for this year?
- 8 **Energy** - the business so far has been a significant contribution to group sales, but you've mentioned you expect aerospace to progressively represent a bigger portion of group revenues in the future. How are you thinking about the balance between division?
- 9 **M&A:** Can you give us an update on your M&A pipeline? What are your ambitions this year?
- 10 **Capex:** How should we see capex as % of sales going forward? Is it fair to expect it to decline and stabilize from FY24 onwards?

Rheinmetall – Key questions

We are hosting Rheinmetall's CEO. Below are 10 key questions:

- 1 **Organic growth.** For FY23 you guided for EUR7.4-7.6bn of revenues. How should we think about FY24? Can you walk us through the progress you see for each division over the next 12 months?
- 2 **Mid-term guidance:** Could you walk us through what you envision for your businesses in the medium-term? Which division will be the key driver of growth and margin expansion?
- 3 **Weapons and Ammo.** Weapons and Ammo has experienced a material step up in growth over the last two years. At the CMD you guided for 2026e at EUR4bn sales and >26% margins. How do you see demand evolving on a multi-year time frame? What are you seeing at the moment in terms of restocking opportunities?
- 4 **Unterlüß:** you have mentioned the goal is for the facility to ramp up to 200k rounds of ammo - how is this progressing? Is the goal still to have 155mm ramp to overall 700k in total? Is there upside on this?
- 5 **Vehicle Systems:** One of your key area that has also gathered a lot of attention has been tanks. What are currently the big opportunities that could arise with your major programmes? How should we think about trucks?
- 6 **F-35:** In the past you have mentioned potential for the programme to ramp up to EUR500-600m in sales mid-term - is this the case still? Can you give us an update on this? What time frame are we looking at for the ramp up on the platform?
- 7 **Defence budgets.** How big of a customer are NATO members for Rheinmetall? How are you currently seeing demand on this front?
- 8 **Capex.** At your CMD you highlighted capex should decrease mid-term after the current peak - can you talk to us about what are the major drivers behind these investments?
- 9 **Free Cash Flow.** Based on everything we have just discussed about capex, defence budgets, growth outlook: How should we think about FCF generation and FCF conversion? What are your key priorities?
- 10 **Shareholder returns.** How should we think about cash deployment/ return to shareholders? What is your main focus at the moment?

MTU Aero – Key questions

We are hosting MTU IR Team. Below are 10 key questions:

1. **GTF situation:** Can you please update us on the GTF situation? Is the inspection program going as expected?
2. **Spares 2024 guidance:** You have guided for low teens spares growth in 2024, which is below peers average, despite expecting high single digit increase in prices? Why do you expect low volumes and work scopes?
3. **MRO growth:** Would you be willing to take additional shop visits related to the GTF inspection if these come at higher margins? Can you help us understand the growth you expect in 2024 for independent and the GTF? Given the guide it seems most of the growth will be driven by GTF? Why is the independent MRO not growing more?
4. **MRO margins:** How should we think about the JVs mid-term? How accretive are the JVs to MRO margins? Any new regarding the ramp up of your Polish & Serbian facilities?
5. **Defence Growth:** 2023 growth was weaker than anticipated. Can you explain what drive this performance? Is there a bit of catch-up effect on your 2024 defence growth guidance? Could you update us on the FCAS situation?
6. **Freight:** You have significant exposure towards the freight market. How do you see freight performing in 2024?
7. **FCF:** The GTF inspections will weigh significantly on your FCF generation mid-term. What are the other key moving pieces on your FCF? How should we think about Capex and Working Capital?
8. **Dividends:** The goal to pay a 40% pay-out is no longer in place 2024-2026E. How should think about shareholder returns from 2026 onwards?
9. **Supply chain:** You have still struggled with supply chain in 2023. How do you see supply chain evolving through 2024?
10. **R&D:** Your R&D decreased significantly post GTF launch. How should we think about R&D with the new GTF advantage? And mid to long-term, how should we think about R&D as the new investment cycle comes in at the end of the decade?

Rolls Royce – Key Questions

We will host Rolls Royce CEO at the conference. Below are 10 key questions for Rolls Royce:

- 1 **Civil Aerospace** - Pricing is one of the main levers you have to improve margins on Aerospace - how are the contract negotiations with customers? Are there still many left to do? How do you see the new pricing focus impacting market share mid-term?
- 2 **Time on Wing** - Improving time on wing is also a big part of the margin story, with particular focus on the T1000 & XWB-97. Can you give us an update on this, what is the time frame of these improvements over the coming years?
- 3 **Biz Jet Market** - How do you see the opportunities in the business jet market mid-term? How do you see market share in this market? How is the profitability of this market?
- 4 **2024 Engine flying hours** - You guided for 100-110% EFH vs 2019 levels. EFH data has been really encouraging through 1Q24. Is there a chance you end up on the high end of the guidance range?
- 5 **Defence** - You grew double digit in 2023. How should we think about defence growth mid-term? How do you expect to benefit from the overall increase in defence spending? Can you remind us of the big programmes for you?
- 6 **Power Systems** - Margins in 2H23 showed a significant improvement vs 1H23. Can you please comment on what drove the significant sequential uplift in margins?
- 7 **Disposal program** - You announced a target of £1-1.5bn of disposals from all your divisions. Can you please update us on this? What is the timeline?
- 8 **M&A** - Your balance sheet will likely provide optionality for bolt on deals in 1-2 years from now. How should we think about M&A for the business?
- 9 **Shareholders returns** - You have already commented that want to achieve an Investment Grade profile before you consider restarting shareholder returns. I don't think we are that far away from an investment grade profile, when you do get there, how are you thinking about returns?
- 10 **Re-entering the narrowbody market & next investment cycle**: You have commented that you plan to re-enter the narrowbody market. Can you update us on this? What technology do you have to offer to a partnership?

SAAB – Key questions

We are hosting SAAB's CFO. Below are 10 key questions:

- 1 **Organic growth:** You have raised your organic growth outlook twice for FY23, and you have also just raised mid-term organic growth from 10 to 15%. Could you give us more colour on the demand and order environment that you see for this year, particularly in Dynamics and Surveillance?
- 2 **Dynamics:** Dynamics is one of your fastest growing divisions at the moment. At the Investor Day you mentioned some areas saw a doubling of the B2B in 2023. Could you give us an overview of how the division has developed over the last 3/4 years? What sort of demand environment are you seeing now? What is your visibility?
- 3 **Surveillance:** Surveillance is the other division, together with Dynamics, which is seeing fast growth at the moment. Could you give us an overview of how the division has developed over the last 3/4 years? What sort of demand environment are you seeing now? What is your visibility?
- 4 **Swedish defence budget:** What are the key events we should look forward to in order to understand how the budget is evolving? Sweden is aiming to increase its % share of budget dedicated to procurement to 60%, how do you expect to benefit from this? Which divisions should benefit more?
- 5 **NATO:** Sweden has now entered NATO – When would you expect to see some first orders/partnerships coming from NATO?
- 6 **Aero/ Gripen:** Could you give an update on the opportunities you see on the Gripen front? Both from Sweden and your export campaigns? How do you see the competition in terms of the fighter jet market in Europe?
- 7 **Aero/ T-7A:** Can you give us an update on how the programme is progressing? How are things in West Lafayette? How should we think about future opportunities?
- 8 **FCF:** Your FCF generation has historically been quite volatile. What sort of measures do you have in place - if any - to improve your cash flow generation going forwards? How should we think about FCF for FY24? How should we think about capex given you are ramping up production?
- 9 **M&A:** Can you give us a bit more colour on what level of investments in capacity do you expect in the short/medium term in light of stronger demand environment.
- 10 **Supply chain:** You highlighted that you are managing well through supply chain challenges so far. How are things now compared to three months ago? What are the key areas you are focusing on at the moment? How much of the inflation can you pass through at the moment?

Safran – Key questions

We are hosting Safran IR Team. Below are 10 key questions:

- 1 **Structural margin improvement:** Are you on track to meet your 2025 margin guidance of 16-18%. What are going to be the drivers that will make you land on the lower or upper end of the range?
- 2 **Aftermarket:** How are you thinking of aftermarket in FY24 given the strong 2023 that we've seen so far? How should we think about volumes and scope?
- 3 **LEAP deliveries & GTF issues:** Airbus mentioned in their Q3 call that Safran could potentially deliver more LEAP engines next year, should Airbus ask for them given the current GTF issues. Is this something you are interested in? And is it doable on your side?
- 4 **LEAP programme:** Where are you on the breakeven point for the LEAP? Is 2025 still a realistic target for the breakeven point? When should we start to see the LEAP at similar levels of profitability vs CFM56? Perhaps in 2028?
- 5 **Equipment:** How has the performance YTD been vs what you expected? Is there anything that we should keep in mind going forwards? Is the 15% margin target still in place?
- 6 **Interiors:** Can you give us an update on interiors? How should we think about the profitability path in 2024?
- 7 **Supply chain:** How is the supply chain performing at the moment? Which areas in particular are facing the pressure?
- 8 **R&D and CapEx:** You have managed to cut R&D significantly through the crisis, what are the big programmes ahead that could drive the R&D/CapEx profile? When do you think you will be back at pre COVID?
- 9 **CFM Rise:** Can you update us on the progression of the CFM Rise? What are the advantages that Rise brings to the table vs the Leap?
- 10 **Capital allocation:** What are your capital allocation priorities now? Do you plan to launch another buyback programme? And how should we think about M&A mid-term? Any updates on the acquisition of Collins Aerospace's actuation business?

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Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

^{R1} 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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