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The Long Case For Hexcel

May 21, 2017 4:00 PM ET12 comments | 2 Likes
by: Michael Liu

Summary

- Meaningful long-term industry tailwinds set to accelerate in the next few years.
- Oligopoly status, industry leadership, and non-competitive contracts should allow Hexcel to capitalize on the majority of this growth.
- Company-specific cash flow and margin improvement in the next few years.
- End markets should improve in the near term (1-2 years).
- ~30% discount to reasonable comps, “pure-play” on secular growth industry, and consolidation premium.

Target Price and Rationale

1. Meaningful long-term industry tailwinds set to accelerate in the next few years.
2. Oligopoly status, industry leadership, and non-competitive contracts should allow Hexcel (NYSE:HXL) to capitalize on the majority of this growth.
3. Company-specific cash flow and margin improvement in the next few years.
4. End markets should improve in the near term (1-2 years).
5. ~30% discount to reasonable comps, “pure-play” on secular growth industry, and consolidation premium.

Based on these factors, we are assigning a 12-month price target of $68/share, representing 32% upside, predicated on Hexcel achieving a P/E of 22.5 (mid-point of our estimates) on projected FY17 results.

Relevant Comps

- We don’t believe that any company in the comp set is directly comparable to Hexcel. With the majority of comps, composite materials are sub-30% of sales and EBITDA. Further individual analysis is required to identify composite materials segment valuation. Relevant comps: Toray (OTCPK:TRYIF), Teijin (OTC:TINLF), Solvay (OTCQX:SVYSF).
- Toray: sales mainly from a long-term supply relationship with Boeing (NYSE:BA). Composites are ~10% of revenue and 25% of EBIT. The composite segment is Toray’s highest-margin and fastest growing one (on both trailing and projected numbers).

Toray is also investing substantial amounts into the segment, for example, by acquiring Zoltek in 2013 and by developing a $500 million new facility more recently. Toray's trailing P/E is 20, although we'd argue that the composite segment is worth a premium due to these factors.

- Toray acquired Zoltek for 112x earnings, although granted Zoltek's earnings fluctuated significantly prior to the buyout. More normalized, the purchase price was also for 4.2x sales, which, although arbitrary, is still significantly above Hexcel's valuation of 2.4x.
- Teijin: composites 15% of revenue, 30% of EBIT. High-margin segment. The segment is projected to decline next year. Overall company P/E of 16.
- Solvay: acquired Cytec late 2015. Cytec was perhaps one of the best comps for Hexcel, as major business lines and supply relationships mostly overlapped. Buyout valuation was for 26.5x earnings; three months pre-buyout Cytec traded for 21x. Recent industry developments, such as advancement of next-gen aerospace programs (which utilize far more composite materials) and the results of the presidential election make us believe that Cytec would garner a higher multiple today. We also believe in assigning Hexcel a premium due to its pure-play nature and demonstrated M&A potential. As a whole, Solvay currently trades for 20x earnings, although again composites are only a portion of overall revenue/profit.
- Given the above factors, we see Hexcel trading for anywhere from 20x to 25x earnings, or 18-47% upside from current prices (based on a forward P/E of 17).

Catalyst

End market softness reversals. Substantial ramps in government military spending into aerospace. Margin/cash flow improvement through 2018. Hexcel's pure-play nature should amplify the effects of macro catalysts.

Industry Tailwinds:

- Aerospace segment (70% FY16 sales): Hexcel supplies major aerospace OEMs (mainly Boeing and Airbus (OTCPK:EADSF)) with composite materials, including carbon fiber and its derivatives. According to various independent studies, carbon fiber is 3-5x stronger and 30-50% lighter than aluminum, its closest comparable. This makes it very valuable in aircraft construction.
- Since the 1970s, the percentage of composites relative to total weight used in new aircraft has consistently increased. Current aircrafts have 50%+ their weight in composite material, and further growth is projected. Boeing recently partnered with Toray, another composite manufacturer, to institute new programs to increase the proliferation of composite material in new aircrafts. This shows that OEMs are committed to further increasing composite material use in their own planes, and that this is a demand-pulled tailwind.

- Global aircraft shipments have also consistently increased for decades. This trend compounds upon composite materials composition growth.
- Reflecting these tailwinds, Hexcel is projecting a high-single digit top-line CAGR through 2020. Longer term, these growth trends should support further consistent growth. Hexcel has grown aerospace sales every year since 2009. Margins have also improved every year since 2009, in part due to FX, but also reflecting Hexcel's advantages and pricing power in the industry.
- On top of this, the Trump administration plans to materially increase military spending in the next few years. A significant portion of this spending should trickle down to Boeing, as it is the dominant force in the military aerospace industry. Boeing was 28% of Hexcel's FY16 sales. Hexcel has not accounted for this development in its projections as new government spending has not yet impacted Boeing's production needs. Once there is more visibility on the subject, management should become more bullish.
- Space & Defense segment (16% FY16 sales): ~50% of this segment's sales are from supplying the rotorcraft end market, mainly in military applications. Military demand for rotorcrafts has declined in recent years. Accordingly, Hexcel's Space & Defense sales have stagnated. Trump's new defense initiative could potentially reverse this trend.
- Industrial Segment (13% FY16 sales): ~50% of this segment's sales are from supplying composite materials for wind turbines. All industry participants have been suffering from demand shortage in recent years. Hexcel management appears confident that this should reverse in 2018. In the longer term, composite materials' substantial advantages over comparables should allow for continuous application expansion into new verticals.
- The majority of the long-term thesis lies with the Aerospace segment. Space & Defense and Industrial applications tend to be more competitive, slower growth, and lower margin, and comprise a smaller portion of Hexcel's overall revenue. Even so, all end markets seem to be at or near short-term inflection points, positioning Hexcel for strong immediate growth. Longer term significant macro tailwinds ensure a continuous growth runway for this industry leader.

Competitive Landscape:

- The composite materials industry is highly consolidated, with only five major competitors: Toray, Teijin (Toho Terex), Mitsubishi, Solvay (Cytec), and Hexcel. Toray is the market share leader, with Teijin and Mitsubishi not far behind.
- There has been some consolidation in recent years. Solvay merged with Cytec in late 2015 for $5.5 billion. Toray acquired Zoltek in 2013 for $583 million. These M&As have made Hexcel the only public pure-play on the composites industry. Other competitors have composites at <30% of total sales and EBITDA. Hexcel is 80%+ composites, with a focus on the highest-growth segment in the industry: aerospace. Investors have

historically valued the aerospace industry (and its corresponding suppliers) at a premium and have recently bid up the prices of many Trump-led defense stocks. Hexcel represents the intersection of this sentiment.
- Toray, Teijin, and Mitsubishi are all based in Tokyo, Japan, and are suffering from the recent strengthening of the JPY. Hexcel doesn't face these same margin headwinds in direct competition.
- Having said this, Hexcel's oligopoly has little direct bidding competition. Supply agreements are characterized by multi-year contracts and many sole-source bids, reflecting competitors' unwillingness to cross-compete, and OEMs' unwillingness switch suppliers. For example, Hexcel has a multi-year supply agreement with Airbus for various end products; Toray has a similar agreement with Boeing. Towards ends of contract periods, OEMs tend to renew them and expand the applications to new product lines. Airbus recently added 13 years onto Hexcel's supply agreement and expanded product coverage to various next-gen products. Similarly, Boeing recently added 10 years to Toray's supply agreement and also expanded Toray's product coverage to its new aircraft. The contracts comprise the majority of the respective suppliers' sales to those end customers.
- Operating margins across the industry are high at 15%+ (for composite segments). Aerospace margins tend to be even higher. Hexcel has the highest EBIT margins in the industry at 23% in FY16. Margins have been growing since 2009. This shows that sales are based on quality and reputation rather than price.
- Substantial barriers to entry: design specifications for aerospace are extremely stringent, and OEMs are unwilling to incur the potential liabilities resulting from low-quality/unproven product. All business is therefore typically taken on only by the industry leaders and/or suppliers with existing relationships. Hexcel has entrenched itself as a leading supplier of composite materials to Airbus and Boeing, which we believe gives it a substantial advantage over potential competitors.
- Hexcel's other two segments face more direct competition, but also comprise a much smaller portion of revenue. Our analysis focuses on Hexcel as an aerospace supplier.

Company Specific:

- Over the last few years, Hexcel has experienced a significant ramp in CAPEX spending. It is currently at peak CAPEX spend with $320 million CAPEX in FY16 (~80% operating cash flow). CAPEX is expected to decline to $160 million/year by 2018-19, freeing up ~$160 million in FCF (~3% cash flow yield) for total FCF of ~$250 million. Hexcel has ample reinvestment opportunities, detailed below:
- Returning to shareholders: currently has a $300 million buyback authorized (6.4% of float). Historically, bought back ~$100-150 million/year. Buyback amounts inversely fluctuate with CAPEX spend; management tries to give all FCF back to shareholders. Expect repurchase rate to increase over the next few years, as FCF will increase and

the share price remains undervalued. Also recently, instituted a small dividend, currently at $0.44 annually (0.85%).

- Investing for future growth: Hexcel has historically made several acquisitions and partnerships in order to remain on top of industry innovation. For example, between two investments in late 2014 and in early 2016, Hexcel acquired Formax UK, which is developing a new lightweight carbon fiber model for emerging industrial applications. Similarly, Hexcel has invested in/partnered with Carbon Conversions Inc. (carbon fiber recycling/repurposing), Oxford Performance Materials (3D printing), and several other smaller companies in order to best position itself for long-term innovation.
- Hexcel is also in the process of ramping up its production by building two new manufacturing facilities in France and Morocco. Development costs are projected at ~$10 million this year, with revenues and margin improvement expected starting Q4. Completion of this development should allow for an easy comp in 2018, as costs die down and sales/margin improvements surface.
- Overall, management seems willing to sacrifice short-term profits in order to optimize long-term growth and to grow market share. At the same time, margins and cash flow should significantly improve over the next few years as the new facilities start contributing and CAPEX decreases.

Mis-valuation/catalysts:

Several reasons exist for investors potentially incorrectly valuing Hexcel:

- Investors may not completely understand the non-competitive dynamics of the composite materials industry and, therefore, underestimate Hexcel's substantial earnings protection against many larger peers.
- Investors may also be overestimating the extent of end market softness. Hexcel shares initially dropped 9% following the recent Q1 earnings miss due to low aerospace sales. Shares quickly recovered to -3% as management assured investors that the miss was due to one-time issues. This shows how cognizant investors are of potential long-term headwinds, which may be causing them to overestimate the extent of current weakness in Hexcel's markets. As end markets improve as projected, this fear should dissipate.
- Lastly, as we show in the comp section, there is not a current viable comp set for Hexcel. All major competitors trade at an average P/E of 20, implying minimal upside to Hexcel shares from current valuations. However, for most comps, their fast-growth/high margin composite segments are being obscured by weaker business lines, implying that investors are valuing the composite business at much higher multiples.

Conclusion:

Substantial positive factors are coalescing in late 2017-18. New facility costs should die down, margins should improve, CAPEX should decrease, and end markets should improve as projected. We see further medium-term upside to Hexcel's earnings based on these factors. In the long term, Hexcel is at the forefront of multiple secular tailwinds, including aerospace/defense sales and a transition to composite materials, and possesses the industry position to best capitalize on these trends. All of this makes us comfortable in assigning a 12-month price target of $68/share, representing 32% upside, predicated on Hexcel achieving a P/E of 22.5 (mid-point of our estimates) on projected FY17 results.

(Editors' Note: This is a republication of an entry in the Sohn Investment Idea Contest. All figures are current as of the entry's submission - the contest deadline was April 26, 2017).

Disclosure: I/we have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

Comments (12)

17900482

I watched a doc called City in the Sky, all about the air industry. It showed the Airbus being put together with a carbon fiber cabin. Does Hexcel manufacture the cabin or just supply the material? They said a carbon fiber cabin can be pressurized allot more than a metal cabin, and the passengers report not suffering from jet lag when flying. Why does Dupont not dominate this market? They have been the leader in composite materials for over a century?

30 Jul 2017, 03:22 AM

Michael Liu

Contributor PREMIUM

Author's reply » Thanks for the comment. Hexcel does both – they sell the material and manufacture, it varies depending on the end market. For the Airbus cabin specifically I believe Hexcel doesn't do the manufacturing. I'd agree that carbon fiber has a lot of benefits in aircrafts, although I'm not sure as to how it would help with jetlag? Also, while Dupont is a leader in composite materials, they don't supply a large amount to the aerospace industry. They do have product on a lot of aircrafts, they just aren't the primary supplier. Their presence in the industry is much smaller than the specialized, dedicated competitors discussed in the article.

31 Jul 2017, 12:20 PM

scorpion.north

My view is that the aerospace segment is the weak spot and the industrial the shining light IF the management is competent enough to see the opportunity.

I think the aersopace segment which is most of revenue is quite well valued in the stock price - plus/minus a bit here and there.

BUT..the real opportunity is in industrial. Aerospace is a niche market. A big niche market. But composites are a sort of commodity product - or will be. When they enter the mass market and infrastructure spending kicks in and we are building a new world out of these light materials you need to be in the biggest market of all - industrial

Do you see any signs management is on to this? If they stick to aerospace and don't look around at what is happening they may be behind the curve

That's my only concern..but I see great opportunity here.

09 Jun 2017, 02:06 PM

Michael Liu
Contributor PREMIUM
Author's reply » Hi Scorpion, thanks for the comment. I think management is of course cognizant of the industrials market potential, however I would disagree that it is a bigger opportunity than the aerospace market. The aerospace industry is huge (several tens of billions a year) and is growing as a result of multiple macro tailwinds. Hexcel has a good, defensible market position here to grow for a long time.

In industrials, as you say, I think composites have risk of becoming commoditized. I'm not sure Hexcel can as easily maintain their 20%+ EBIT margins in industrials. Although there will likely be substantial opportunity there in the future for the reasons you cited, it will be hyper-competitive and not as conducive to moats. I'm not sure about management's mindset, but from past commentary it seems like their focus is still mainly on aerospace (although this may shift as markets change).

09 Jun 2017, 10:23 PM

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scorpion.north
I just thought of something else, like Precision Castparts or even Priceline, Hexcel might be considered an indirect play on the travel market. Perhaps a safer way to play it as travel sites seem to be getting more and more commoditized as well.

10 Jun 2017, 11:14 AM

Michael Liu
Contributor PREMIUM
Author's reply » Hi Transcripts – thanks for the comment! With regards to the taxes I think it's pretty common for there to be large differences between the GAAP tax and cash taxes of companies. In Hexcel's case they have various deferred tax assets causing this, but most companies I believe are the same.

In terms of content per unit, yes Hexcel is more focused on Aibus and Toray on Boeing in supplier relationship. I believe this accounts for the discrepancy you're talking about but I haven't looked into it too deeply.

07 Jun 2017, 12:45 AM

Transcripts&10-K's
Awesome, thanks for the reply Michael.

07 Jun 2017, 09:05 AM

Transcripts&10-K's
Hi Michael - very good work here!

Quick question: there has been a large and consistent discrepancy between reported income taxes and cash taxes at HXL. Do you have any thoughts on this? I've struggled to put my finger on why this has happened in each of the past 5+ years.

Also, I'm curious about the large discrepancy between HXL's content per unit on the A350 (~$5M) and the B787 (~$1.4M). Is your understanding that this simply reflects the competitive dynamics - said differently, Toray is the primary supplier for Boeing and Hexcel is the primary supplier for Airbus?

Thanks in advance!

06 Jun 2017, 03:26 PM

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jphein

Thank you for sharing your well-thought-out investment thesis

05 Jun 2017, 11:48 AM

Michael Liu

Contributor PREMIUM

Author’s reply » Thanks for the kind words jphein!

05 Jun 2017, 07:03 PM

Ioannis Stamatopoulos

Contributor

Thank you for your analysis which covers all bases of the investment thesis in Hexcel. If you have conviction and recommend it, is there a reason you don't own the stock? While relative valuation has merits, I'm a stronger believer in DCF analysis. Would therefore be interested to hear your thoughts on the cash flows, growth assumptions and cost of capital you would use to value Hexcel using an alternative method.

I was convinced that Hexcel was a very special "till death do us apart" company from the moment I did my homework on them. Having recently read that Lou Simpson (who managed the investment portfolios of Geico for Warren Buffet) included Hexcel in his very concentrated portfolio of 10-15 stocks was the best possible reassurance I could ever get on the conceptual soundness of the thesis. This year is transitory, but from 2018 onwards, all financial metrics (revenues, eps, free cash flows) should improve a lot, with the share price following.

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05 Jun 2017, 11:48 AM

Michael Liu

Contributor PREMIUM

Author’s reply » Hey Ioannis, thanks for the comment. I don't currently own a position because I'm primarily a microcap investor (<$300 million market cap). I had just found Hexcel to be an especially interesting mid-cap, but it's not quite my taste as an investment just due to its size. I'm not sure what would be the best assumptions for a DCF for Hexcel. I'd say you could probably safely model a 7-9% growth rate for the next five years, with maybe a 9% cost of capital, however you'd also have to take into account that they go through pretty substantial CAPEX cycles as described in the article that would be difficult to model. Just as a matter personal preference I've always tried to avoid DCF models for the usual arguments (small changes make big valuation discrepancies).

I'd agree that Hexcel is a great company for the long-term. The dynamics of the aerospace industry for the long-term are great, then you have the increase of carbon fiber in making the airplanes as well.

05 Jun 2017, 07:02 PM