

Aerospace and Defense

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Company	Rating	Price	Target
Aerospace and Defense			
ATRO-NASDAQ	Hold	US\$28.94	US\$32.00
BA-NYSE	Hold	US\$327.00	US\$370.00
DCO-NYSE	Buy	US\$50.90	US\$54.00
HXL-NYSE	Buy	US\$76.73	US\$90.00
SPR-NYSE	Hold	US\$78.88	US\$88.00

Priced as of close of business 16 December 2019

Boeing announces MAX production pause

Boeing (BA) today announced that it was suspending production of the 737 MAX effective in January. Considering the anticipated two-week December shutdown at the Boeing Renton 737 factory, the MAX production suspension is effectively starting the end of this week. With almost 400 MAX in inventory (basically 9 months at 42/month) and continued uncertainty on the exact timing of the MAX return to service (RTS), it is not surprising BA has taken the steps to suspend its production. However, negotiations with suppliers are ongoing, and it is not yet determined at which level key suppliers, such as Spirit AeroSystems, will continue to produce 737 MAX aircraft (note that SPR had been maintaining its production at 52/month). The expected impact on Boeing and its suppliers is significant, but the exact financial details are still to be worked out, and we expect the supply chain to maintain some MAX production, but likely at a lower level than the current production rates.

Boeing indicated that it views a temporary pause as the least disruptive to its supply chain. Boeing in fact indicated that it is not expecting any layoffs or furloughs as a result of the production pause. We believe BA will do all possible to ensure that its suppliers are able to maintain their 737 employees to ensure that once BA is able to start deliveries of the 737 again, it has the ability to ramp production as quickly as possible. We estimate that the MAX, at 42/month, is a \$1.4B monthly cash burn for Boeing. Boeing did maintain its current dividend, and we believe BA has sufficient financing capacity to weather an extended pause. However, we also believe part of the decision by Boeing to pause its MAX production is to lessen the perceived pressure on the FAA and other regulators.

We now view an RTS for the MAX in February as a best-case scenario. It is clear that the FAA has been frustrated with Boeing's pressure and public statements regarding the MAX. BA is still looking to complete several of its key milestones soon, but this has taken longer than expected. While BA has not indicated that the pause will be in place until the successful RTS, at a minimum BA will want better visibility on the key milestones, including the JOEB training requirements. Moreover, it is likely BA will gradually "wake-up" the factory after the pause, and it could take several months to get rate back to the 42/month level.

As a reminder, the 737 MAX is most important within our universe for Spirit AeroSystems (SPR), Ducommun (DCO), Hexcel (HXL) and Astronics (ATRO). While BA will likely keep most suppliers running at some level, it will be a supplier-by-supplier analysis, depending on a number of factors. BA will also complete all of the MAXs current in-process, which will add ~40 to the parked inventory. Once BA reaches an agreement with key suppliers, such as SPR, we will get a sense as to the exact production impact.

In our view, the risk of a pause in 737 MAX production extends well beyond the near-term financial impacts. For example, the potential loss of talent, access to capital, and incremental risk on the supply chain all create substantial uncertainty about Boeing's ability to increase production levels once the pause ends. We believe BA's ability now to get back to 52/month is pushed substantially to the right, and the supply chain's ability to eventually support higher rates, such as the planned 57/month, are now much more uncertain. BA's push to save near-term cash makes sense, but unfortunately what was unthinkable just a few months ago has now become a reality. We continue to favor stocks with more commercial AM and defense exposure.

Boeing 737 MAX supplier exposure

Boeing (BA) announced today it was suspending production of its 737 MAX aircraft. Boeing had been producing the aircraft at 42/month since the March 2019 grounding, with the supply chain running somewhere between 42-52/month, depending on the supplier.

Boeing has not identified yet when it expects to resume 737 production, likely timed with the return to service (RTS) of the aircraft. We assume that a best-case scenario has the production pause extending into the middle of February 2020, and potentially longer. Note that it is likely Boeing will need a period of time to “wake-up” the 737 factory once it resumes production, so the timing of the return to 42/month, and even 52/month, could be pushed further to the right depending on the length of the pause.

Moreover, Boeing has not identified how much the supply chain will lower production rates. The chart below highlights the importance of the 737 MAX to our universe, based on the lower 2019 production levels.

Figure 1: Boeing 737 MAX supplier exposure

737 MAX Supplier Analysis, 2019E				
\$M Company	Ticker	Shipset (\$M)	737 MAX 2019E revenues	
			Revenues	% of total
Astronics	ATRO	\$0.1	\$53	7%
Crane Co	CR	\$0.2	\$112	3%
Ducommun	DCO	\$0.2	\$106	15%
Hexcel	HXL	\$0.4	\$224	9%
Spirit AeroSystems	SPR	\$6.5	\$4,056	52%
TransDigm Group	TDG	\$0.5	\$281	5%
Triumph Group	TGI	\$0.3	\$160	6%

Source: Company Reports, Canaccord Genuity estimates

However, we do expect some step-down in production across the supply chain. However, considering Boeing’s desire to minimize supply chain risk, and do all possible to ensure it is positioned to eventually take rates higher on the 737 MAX, we believe Boeing will continue to absorb much of the financial impact and will keep its supply chain relatively supported.

Spirit AeroSystems (SPR) is the most at risk, considering ~50% of its revenues come from the 737. We expect SPR will see a rate reduction from its current 52/month, but the exact level has not yet been determined, and we believe negotiations with Boeing will likely take into 2020 to finalize. SPR had previously planned to shut its 737 line for two weeks starting on December 23, 2019.

After SPR the suppliers with the most risk include Ducommun (~15% of 2019 sales), Hexcel (~10% of 2019 sales) and Astronics (~7% of 2019 sales). In terms of sentiment, we believe the additional step-down in the 737 MAX volume is a positive for the commercial AM as well as defense stocks.

Boeing maintained its current dividend (\$2.055/share) for Q1/19. However, BA is not expected to resume any buy-back activity until the successful RTS of the 737 MAX, at the earliest. Boeing will provide further quantification on the 737 MAX cash impact as it closes its 2019 books and has to make assumptions on the block and cash impact for 2020.

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Investment Recommendation

Date and time of first dissemination: December 16, 2019, 23:08 ET

Date and time of production: December 16, 2019, 21:50 ET

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	876*	100.0%	

*Total includes stocks that are Under Review

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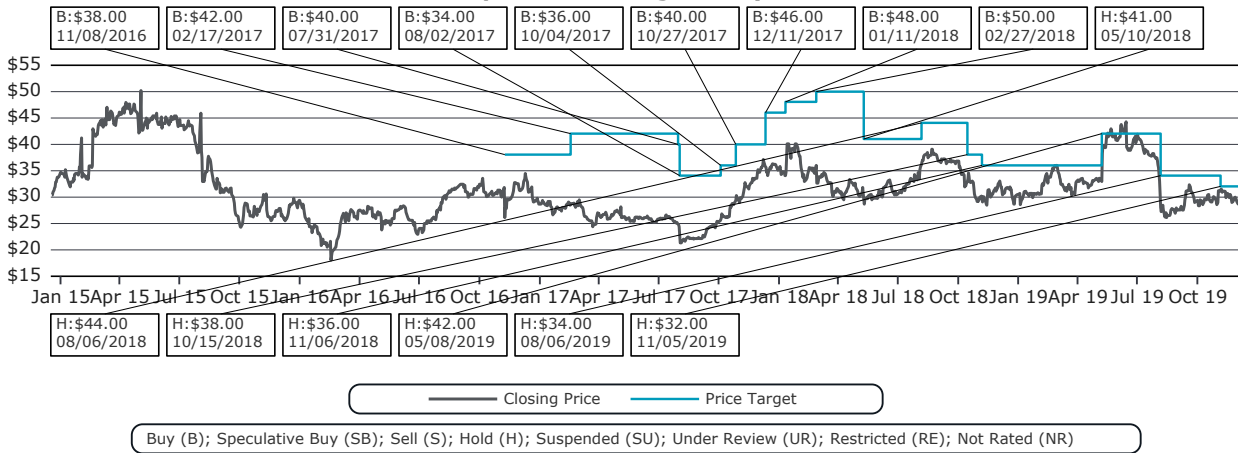
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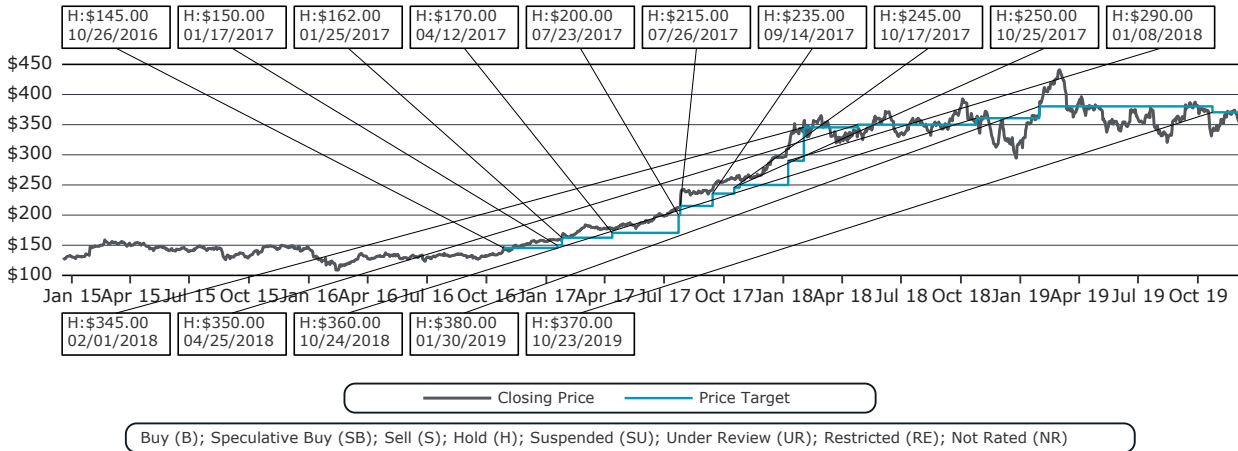
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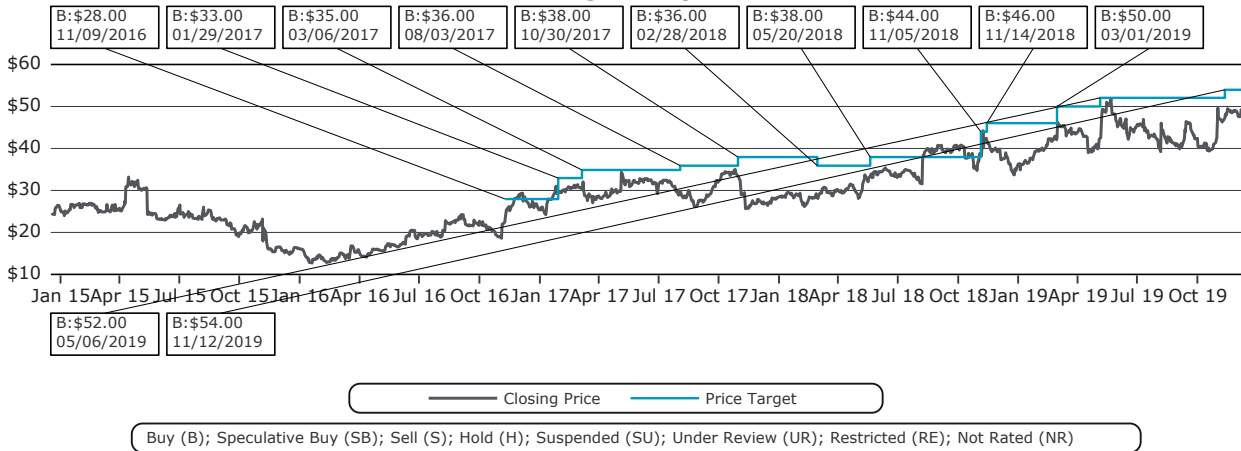
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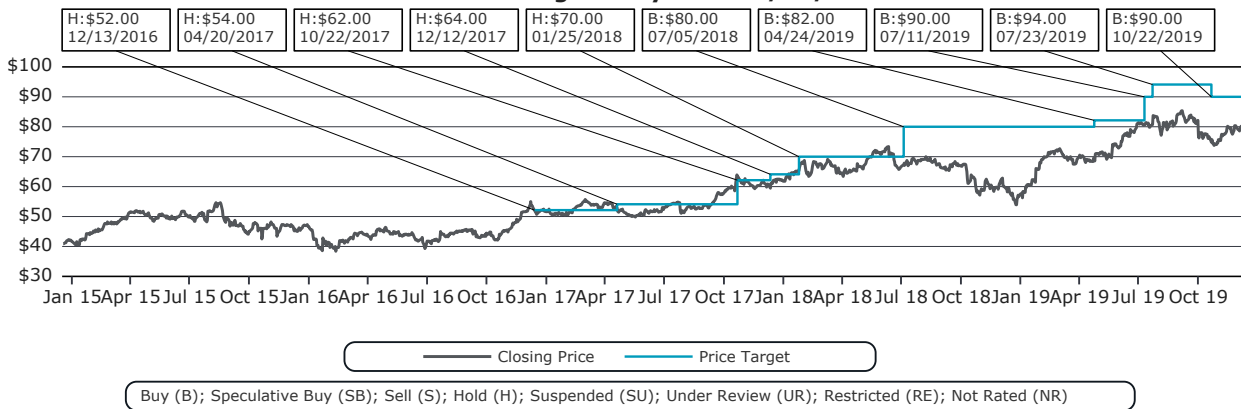
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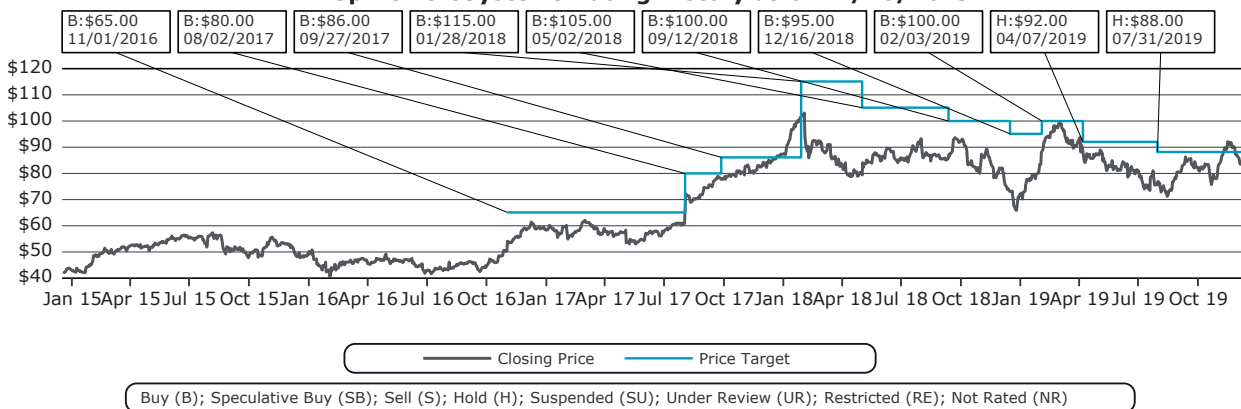
Ducommun Rating History as of 12/16/2019



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