

Hexcel Corporation: Sentiment Pressured By 737 Max Uncertainty

Nov. 4, 2019 7:26 AM ET 4 comments | 5 Likes

by: BOOX Research

Summary

- Hexcel reported Q3 earnings with EPS ahead of expectations, while revising the range of full year revenue growth guidance slightly lower.
- Company sees high uncertainty related to reduced production schedule of the Boeing 737 MAX and growing inventories while the fleet is grounded.
- The company has a solid dividend growth profile, but we are cautious on shares at the current level.

Hexcel Corporation (NYSE:HXL) is a leading manufacturer of composites for the aerospace, defense, and other industrial markets. The products are diverse across a number of advanced materials like carbon fiber and specialty fabrics used in a range of applications. Growth has been strong over the past decade fueled by growing adoption of composites in key components particularly within aircraft replacing traditional heavier weight metals. Hexcel's stock has been a big winner, up about 65% in the past three years with steady growth and firming profitability. This article recaps the latest earnings release and our view on where the stock is headed next.



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(source: FinViz.com)

HXL Q3 Earnings Recap

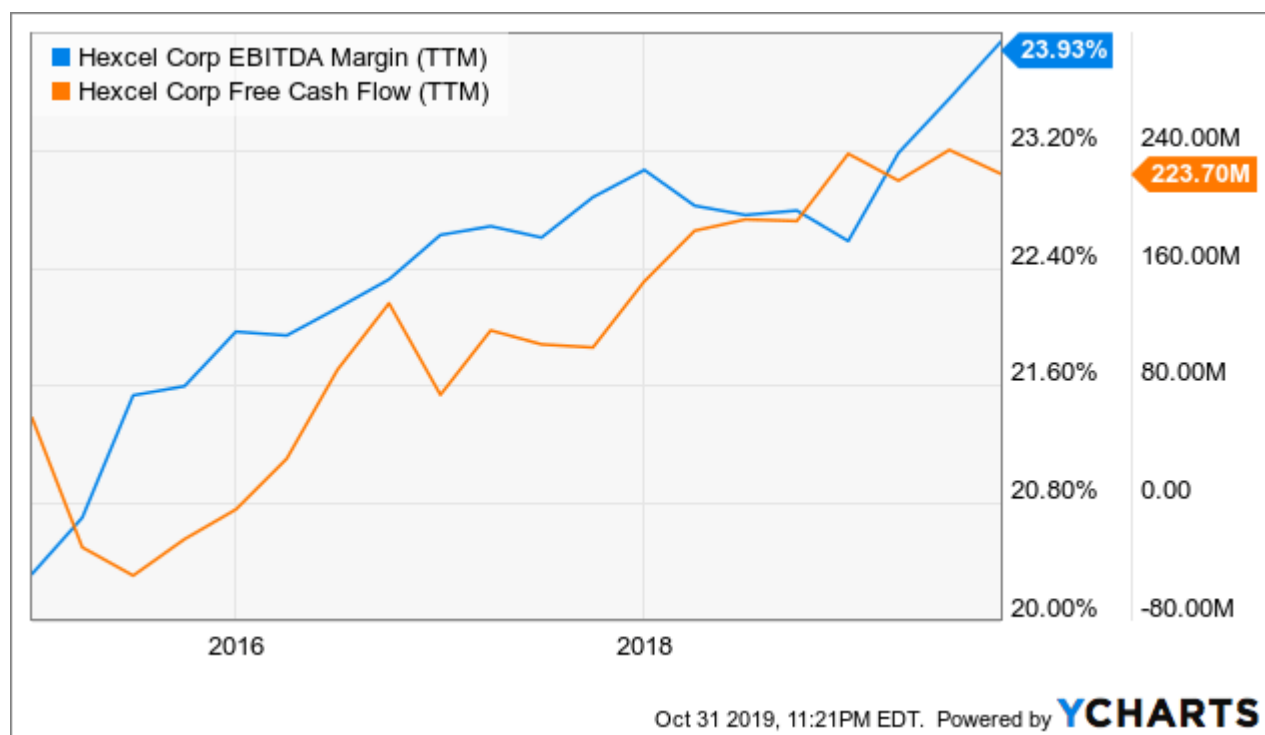
Hexcel Corp. reported Q3 earnings on October 21st with non-GAAP EPS of \$0.90 which was \$0.02 ahead of expectations. GAAP EPS of \$0.93 also beat estimates. On the other hand, revenues of the quarter up 5.9% year over year to \$572.5 million missed the consensus by \$26.4 million. The Commercial Aerospace segment, which represents 67.4% of total sales, increased by a relatively muted 3.4% y/y.

Summary of Results from Operations						
(In millions, except per share data)	Quarters Ended September 30,			Nine Months Ended September 30,		
	2019	2018	% Change	2019	2018	% Change
Net Sales	\$ 572.5	\$ 540.5	5.9 %	\$ 1,791.4	\$ 1,628.1	10.0 %
Net sales change in constant currency			6.6 %			11.2 %
Operating Income	109.9	96.5	13.9 %	327.8	275.4	19.0 %
As a % of sales	19.2 %	17.9 %		18.3 %	16.9 %	
Net Income	80.3	80.1	0.2 %	233.4	210.5	10.9 %
Diluted net income per common share	\$ 0.93	\$ 0.91	2.2 %	\$ 2.71	\$ 2.35	15.3 %
Adjusted Operating Income	\$ 109.9	\$ 96.5	13.9 %	\$ 327.8	\$ 275.4	19.0 %
Adjusted Net Income	77.3	70.5	9.6 %	230.4	199.6	15.4 %
Adjusted diluted net income per share	\$ 0.90	\$ 0.80	12.5 %	\$ 2.68	\$ 2.23	20.2 %

Source: Company IR

This quarter the revenue increase was supported by the Airbus (OTCPK:EADSF) A320neo and Boeing (BA) 787 production, while overall growth was dragged lower by reduced demand from the Boeing 737 MAX which has presented a lower monthly build rate. The Space & Defense segment has been a growth driver and revenues this quarter increased by 21.5% y/y, supported by orders for the Lockheed Martin (LMT) F-35 fighter jet.

Firm-wide, the gross margin increased to 27.6% from 26.5% last year, which in combination with tight cost control, drove a higher operating margin of 19.2% compared to 17.9% last year. The EBITDA margin of 21.5% in Q3 and 23.93% over the trailing twelve months has climbed higher steadily in recent years along with free cash flow.



Data by YCharts

In terms of guidance, Hexcel revised its revenue target slightly lower to a range between \$2.34 and \$2.4 billion, from a previous \$2.375 to \$2.475 billion, citing uncertainties related to the Boeing 737 MAX production. Free cash flow guidance at "greater than \$250 million" if confirmed would represent an increase from \$237 in 2018 and \$151 million in 2017 as a strong point for the company. Management made the following comments in the conference call:

We continue to see growth in Commercial Aerospace although slowed by the effects of the Boeing 737 MAX grounding. The decrease in MAX production did not significantly affect our sales during the first half of the year as we benefited from a few Boeing suppliers taking advantage of the grounding to catch up and build inventory in Q2.

However, as the grounding extended, the channel inventory grew, and as Q3 progressed, more than two thirds of our Boeing 737 MAX ships sales were affected by the lower build rates. Today, we remain optimistic for a Boeing 737 MAX return to service and resumption of growth with higher production levels following regulatory approvals. Unfortunately, the uncertain timing of return to service has pushed sales to the right and required us to revise our sales guidance for the year as you read in our release last night.

2019 Guidance

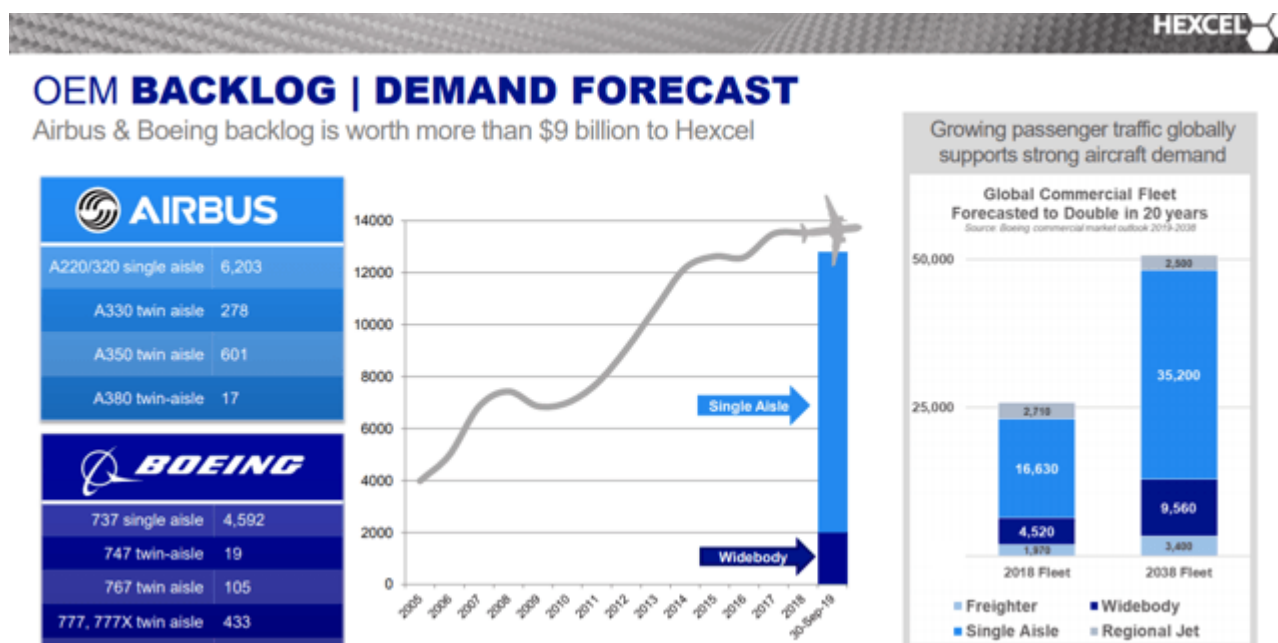
- Sales of \$2.340 billion to \$2.400 billion (previously \$2.375 billion to \$2.475 billion)
- Adjusted diluted earnings per share of \$3.43 to \$3.53 (unchanged)
- Free cash flow greater than \$250 million (unchanged)
- Accrual basis capital expenditures of \$170 million to \$190 million (unchanged)

Source: Company IR

The other development in the quarter was an update to the capital deployment. Hexcel has repurchased \$66.9 million over the first nine months of 2019 and still has \$318 million remaining under the authorized share repurchase program. The company ended the quarter with a strong liquidity position considering a current ratio of 2.24x.

HXL Analysis And Forward-Looking Commentary

Hexcel reached an all-time high of \$87 in late August and is since down about 14% from that level. We think some of that weakness is related to industry sentiment surrounding ongoing uncertainties from the impact of the Boeing 737 MAX fleet grounding and reduced build rate. Next to the Airbus A220/320 aircraft with an OEM backorder of 6,203 aircraft, the Boeing 737 is the second most important aircraft for Hexcel with an OEM backlog of 4,592. There is an expectation that the aircraft can regain industry certification in early 2020 but it remains to be seen how it will impact the production timetable.



Source: Company IR

Valuation

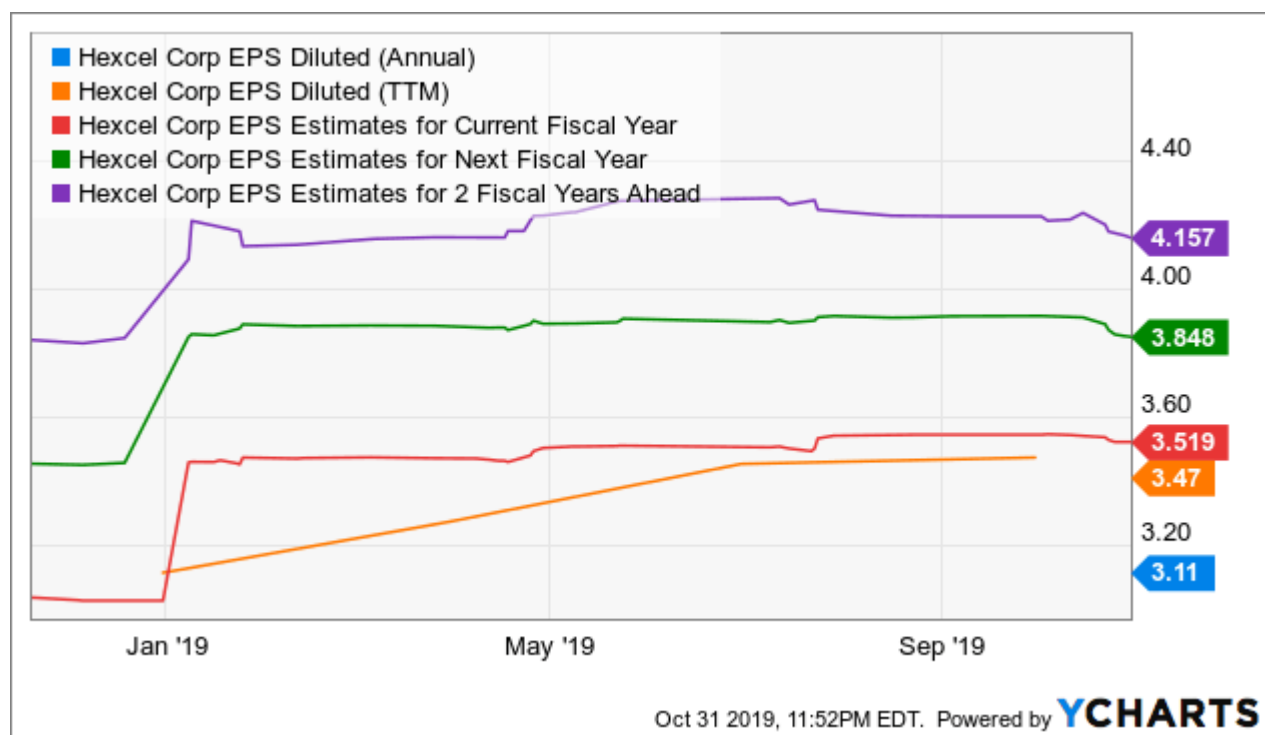
Taking a look at valuation multiples, a current P/E ratio at 21.5x and an EV to EBITDA multiple of 13.1x are relatively reasonable considering an expectation for earnings growth above double digits for the next three years. On the other hand, the ratios here are slightly more concerning considering they are above the historical 5-year and 10-year average for the company, even in context that revenue growth has slowed. Earnings are still strong, but we like to see multiples expansion coinciding with top-line growth acceleration. In this regard, the stock has a lower margin for error going forward before it begins to appear expensive.

Hexcel Corp (HXL) - Valuation Multiples Times Series

	Latest	2018	2017	2016	2015	2014	2013	2012	2011	2010	2009
PE Ratio (TTM)	21.8	18.4	20.0	19.4	19.0	19.6	24.2	16.8	17.9	23.5	22.8
PS Ratio (TTM)	2.8	2.3	2.9	2.4	2.4	2.2	2.7	1.7	1.8	1.5	1.1
Price to Book Value	4.5	3.7	3.9	3.7	3.7	3.4	3.8	2.7	3.0	2.7	2.2
Price to Free Cash Flow (TTM)	29.1	21.5	54.0	35.9	87.4	70.7	58.4	193.5	47.2	23.2	17.1
PEG Ratio (TTM)	4.5	28.5	2.9	3.2	1.3	1.3	1.6	0.9	0.2	0.7	--
EV to EBITDA (TTM)	13.1	11.7	13.8	11.8	11.9	11.4	14.1	9.5	10.5	11.0	10.4
EV to EBIT (TTM)	17.4	15.6	17.9	14.9	14.6	14.1	17.2	11.7	13.5	15.5	15.1
EV to Revenues (TTM)	3.1	2.6	3.2	2.7	2.6	2.3	2.8	1.8	1.9	1.7	1.4
EV to Free Cash Flow (TTM)	33.0	24.4	41.8	72.9		74.4	59.6		207.4	25.9	21.0
EV to Assets (Quarterly)	2.5	2.0	2.3	2.2	2.2	2.1	2.5	1.8	1.9	1.6	1.3

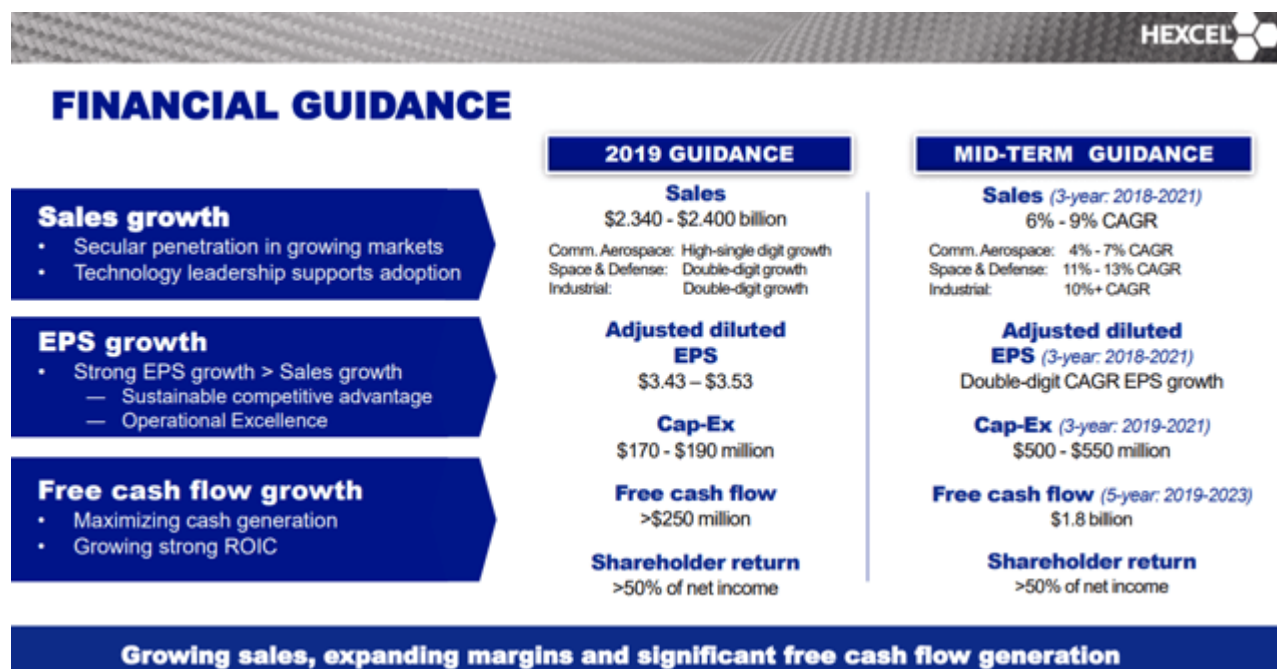
Source: data by Ycharts/table author

Based on management guidance for 2019 EPS, which is within the market consensus estimate, Hexcel is set to grow earnings this year about 12% and about 9%-10% for each of the next two years. Essentially, the stock has slowing revenue growth, but stronger margins and tight cost controls are driving EPS.



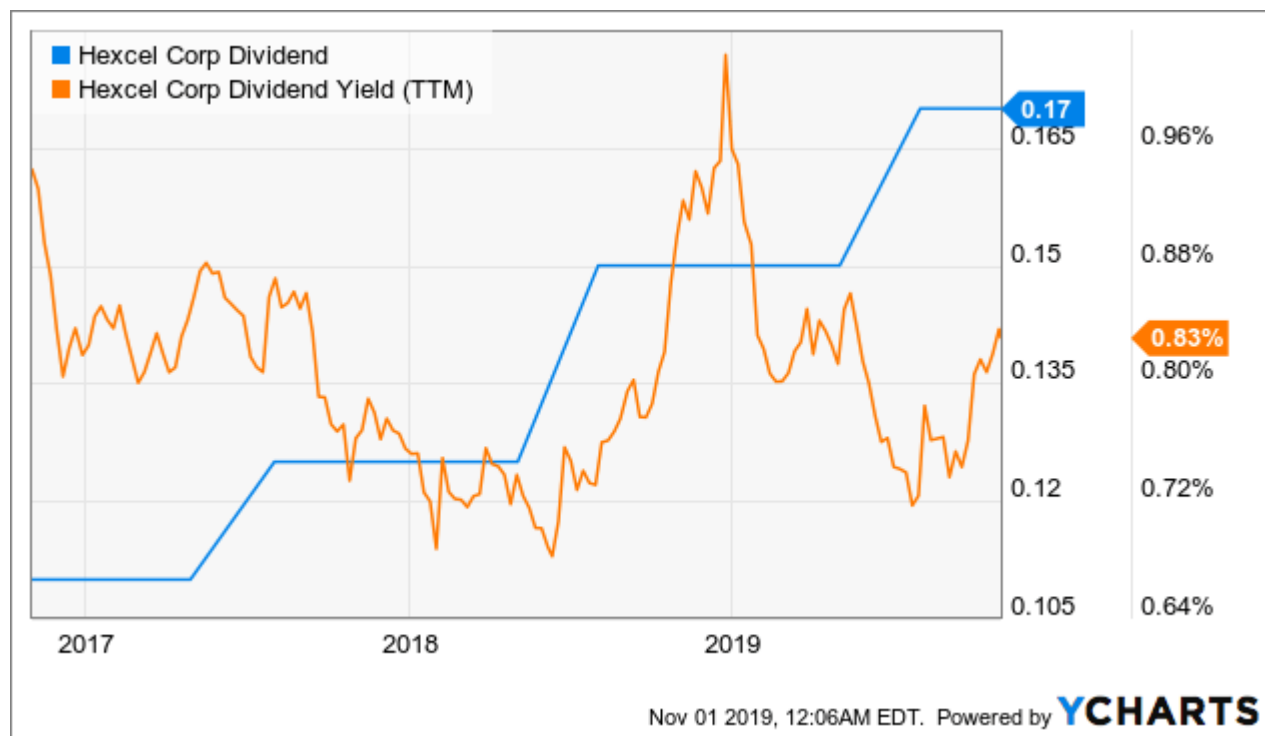
Data by YCharts

The company's free cash flow target of \$250 million for this year could grow to average \$388 million per year through 2023 considering management's midterm guidance of free cash flow at \$1.8 billion between 2019 and 2013. Indeed, this is one of the most positive aspects of the stock as an investment which also represents flexibility going forward to raise the dividend.



Source: Company IR

Since initiating a quarterly dividend back in 2015, HXL has increased the rate every year since to reach a current \$0.17 per share which yields 0.8%. Considering the annualized amount represents a payout of about \$57 million, or a 22% payout ratio on this year's free cash flow guidance, we see room for further dividend growth around 10% for each of the next three years. We like HXL as a dividend growth stock but more cautious on the share price at current levels.



Data by YCharts

Risks

The main risks here beyond a global cyclical slowdown come down to operating developments of Hexcel's key customers. In many ways, the future of Hexcel is tied to the growth and success of companies like Boeing, Airbus and defense contractors. The current imbroglio with the 737 MAX remains a fluid and fast-changing development as the fleet remains grounded awaiting regulatory approvals. It remains to be seen if the model's market demand and existing order book face long-lasting repercussions, even if the fleet returns to operation in the year ahead. To the upside, a faster than expected global certification to the 737 should result in more positive sentiment in support of growth expectations for HXL.

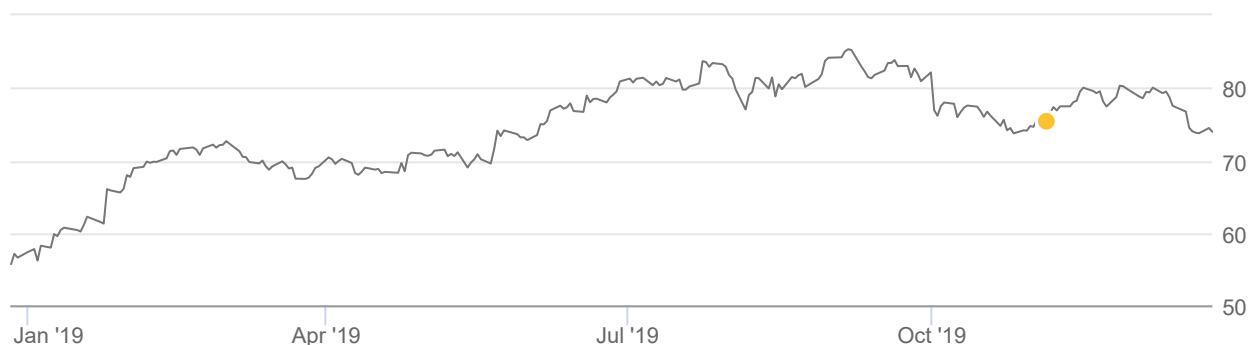
Takeaway

We balance a recognition of Hexcel's market leadership position, strong earnings, and expectations of growing free cash flow against our view that valuation multiples remain at a premium level. We expect shares to trade with higher volatility as the 737 situation weighs on sentiment. **We rate shares of HXL as a hold** with higher risks in the near term with potential downside to current quarter growth and earnings estimates.

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 (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

BOOX Research's ratings on HXL

Latest rating: Neutral Very Bullish Bullish Neutral Bearish Very Bearish



All Ratings by BOOX Research »

Comments (4)

autofocus111

I estimate 737MAX at ~10% of total revenues for HXL. Industrial segment was seeing strong growth with the introduction of new wind turbines but that has tapered off recently. They've been doing some investments that were a drag on FCF but that has been largely completed. Also a couple of recent acquisitions that they have to now integrate and streamline. Good company overall and well-positioned for the future. I had owned it for a few years but sold when the BA plane issue arose. Still looking for more clarity there and maybe a better price to re-enter.

05 Nov 2019, 12:40 PM

MTSkyInvesting

Pure nonsense.

MAX will be approved by year end.

There is no uncertainty.

04 Nov 2019, 07:52 AM

BOOX Research**Contributor PREMIUM**

Author's reply » "uncertainty" is literally a direct quote from company earnings press release (edited)

04 Nov 2019, 08:19 AM

Klimbim

@MTSkyInvesting

MT. It is by no means certain that the MAX will be approved by the end of the year. As this issue drags on, it becomes more likely that the max will never fly again.

However, the demand for high strength low weight materials is increasing and HXL is in the right place. The BA MAX backlog is ~4500 aircraft, and if BA cannot deliver, the demand will not disappear, it will be dissipated elsewhere.

04 Nov 2019, 08:28 AM