Howmet Aerospace Inc. (NYSE:HWM) Q4 2023 Earnings Conference Call February 13, 2024 10:00 AM ET

Company Participants

Paul Luther - Vice President, Investor Relations
John Plant - Chairman and Chief Executive Officer
Ken Giacobbe - Executive Vice President and Chief Financial Officer

Conference Call Participants

Douglas Harned - Bernstein
Robert Stallard - Vertical Research
Peter Arment - Baird
Myles Walton - Wolfe Research
Sheila Kahyaoglu - Jefferies
Noah Poponak - Goldman Sachs
Scott Mikus - Melius Research
Seth Seifman - JPMorgan
David Strauss - Barclays

Operator

Hello and welcome to the Howmet Aerospace Fourth Quarter 2023 and Full Year Earnings Conference Call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions]

I would now like to hand the call over to Paul Luther, Vice President of Investor Relations. Please go ahead.

Paul Luther

Thank you MJ. Good morning and welcome to the Howmet Aerospace fourth year and full year 2023 results conference call. I'm joined by John Plant, Executive Chairman and Chief Executive Officer; and Ken Giacobbe, Executive Vice President and Chief Financial Officer. After comments by John and Ken, we will have a question-and-answer session.

I would like to remind you that today's discussion will contain forward-looking statements relating to future events and expectations. You can find factors that could cause the company's actual results to differ materially from these projections listed in today's presentation and earnings press release and in our most recent SEC filings.

In today's presentation references to EBITDA, operating income, and EPS mean adjusted EBITDA excluding special items, adjusted operating income excluding special items, and adjusted EPS excluding special items. These measures are among the non-GAAP financial measures that we've included in our discussion.

Reconciliations to the most directly comparable GAAP financial measures can be found in today's press release and in the appendix in today's presentation.

With that I'd like to turn the call over to John.

John Plant

Thanks PT and welcome everyone to the 2023 year-end results call. If you move to slide four, please. And I'll start off by saying Howmet's fourth quarter results were indeed very strong. Revenue, EBITDA, EBITDA margin, and earnings per share all met or exceeded the high end of guidance. More importantly, we continue to outgrow each of our respective markets.

Specifically, revenue was $1.73 billion, an increase of 14% year-over-year, and with commercial aerospace up 22%. EBITDA was $398 million, which was an increase of 18% year-on-year, while EBITDA margin was in line with Q3 at a solid 23%. Second half EBITDA margin was 30 basis points greater than the full year average, and Q4 earnings per share increased by a significant 39%.

For the full year, revenue was up 17%, driven by commercial aerospace up 24%, and EBITDA was up 18%. Earnings per share continued to improve annually and was a record $1.84 per share, which is an increase of 31% year-over-year.

Moving to the balance sheet and free cash flow. Free cash flow was a record and above the high end of guidance at $682 million. And in the fourth quarter, Howmet continued with its balanced capital allocation strategy by buying back another $100 million of common stock and repaying another $100 million of debt as part of its reduction of the 2024 bonds.

Moreover, we refinanced the $400 million of the 2024 bonds at a reduced interest rate. The combination of these actions further reduces annualized interest expense by $10 million going into 2024. This goes towards continued improvement in free cash flow yield and improved earnings per share. Lastly, net leverage improved to a record 2.1 times, which was in line with expectations.

Each segment contributed with Engine Products and Forged Wheels delivering record profits. We were pleased with the pickup in faster margins to adjust in excess of 22% EBITDA margin. Ken's going to detail all of this in his commentary.

Having completed a strong 2023, the majority of my comments today will focus on the outlook for 2024 and will be covered in the guidance section after covering the historical results. We look forward to a healthy 2024.

And now over to Ken.

Ken Giacobbe

Thank you, John. Let's move to slide five for an overview of the markets. All markets continue to be healthy and we are well-positioned for future growth.

Revenue was up 14% in the fourth quarter and up 17% for the full year. The commercial aerospace recovery continued throughout 2023 with revenue up 22% in the fourth quarter and up 24% for the full year driven by all three aerospace segments.

Commercial aerospace has grown for 11 consecutive quarters and stands at just over 50% of total revenue. Growth continues to be robust, supported by the demand for new, more fuel efficient aircraft with reduced carbon emissions and increased spares demand.

Defense aerospace was flat for the fourth quarter. However, defense aerospace was up 10% for the full year driven by legacy fighter programs and spares demand. Commercial transportation was up 5% year-over-year in the fourth quarter and up 9% for the full year driven by higher volumes.

Finally, the industrial and other markets were up 21% in the fourth quarter, driven by oil and gas up 34%, IGT up 24%, and industrial up 9%. For the full year, the industrial and other markets were up 17% year-over-year, driven by oil and gas up 38%, IGT up 16%, and general industrial up 7%. In summary, another strong year across all of our end markets.

Now let's move to slide six. Consistent with prior calls, we will start with the P&L and focus on enhanced profitability. For the full year, revenue, EBITDA, EBITDA margin, and earnings per share all met or exceeded the high end of guidance.

For the full year, revenue was $6.64 billion, up 17% year-over-year. EBITDA was $1.5 billion, an outpaced revenue growth by being up 18% year-over-year, while absorbing the addition of approximately 1,850 net new hires.

EBITDA margin for the year was strong at 22.7%, with a fourth quarter exit rate of 23%. Adjusting for the year-over-year inflationary costs pass-through, the flow-through of incremental revenue to EBITDA was approximately 31% in the fourth quarter, and approximately 26% for the full year.

Earnings per share was a record $1.84, up 31% year-over-year. Additionally, Q4 earnings per share was a record at $0.53 per share versus the prior quarterly record of $0.46 per share. In the quarter, we had two minor benefits impacting earnings per share, $0.01 associated with the Q4 favorable tax rate, and $0.01 related to favorable foreign currency. The fourth quarter represented the 10th consecutive quarter of growth in revenue, EBITDA, and earnings per share.

Now let's cover the balance sheet. The balance sheet's never been stronger. Free cash flow for the year was a record $682 million, which exceeded the high end of guidance. As we have done every year since separation, we continue to drive free cash flow conversion of net income to our long-term target of 90%. The year-end cash balance was a healthy $610 million with strong liquidity.

For the full year, we reduced the 2024 debt tower by approximately $875 million. $475 million came from the balance sheet, and $400 million was refinanced at a fixed rate with an approximate coupon of 3.9%. Net debt to EBITDA improved to a record low of 2.1 times. All long-term debt is unsecured, and at fixed rates, which will provide stability of interest rate expense into the future

Howmet's improved financial leverage and strong cash generation were reflected in S&P's December rating upgrade to BBB minus. With this upgrade, we are now rated as investment grade by two of the three rating agencies.

Finally, moving to capital allocation. We continue to be balanced in our approach. For the year, approximately $800 million of cash on hand was deployed to debt paydown, common stock repurchases, and quarterly dividends. The previously mentioned debt reduction actions during the year lowers annualized interest expense by approximately $29 million.

We also repurchased $250 million of common stock at an average price of $47.76 per share. This was the 11th consecutive quarter of common stock repurchases. Share buyback authority from the Board of Directors stands at approximately $700 million. The average diluted share count improved to a record low Q4 exit rate of 413 million shares.

Finally, we continue to be confident in free cash flow. In the fourth quarter, the quarterly common stock dividend was increased by 25% to $0.05 per share.

Now let's move to slide seven to cover the segment results for the fourth quarter. Engine products continued its strong performance. Revenue increased 16% year-over-year to $852 million. Commercial aerospace was up 14%, and defense aerospace was up 18%. Both markets realized higher build rates and spares growth. Oil and gas was up 25%, and IGT was up 24% as demand continues to be strong.

EBITDA increased to 22% year-over-year to a record $233 million. EBITDA margin increased 120 basis points year-over-year to 27.3%, while absorbing approximately 180 net new employees in the fourth quarter and approximately 1,030 net new employees for the full year.

For the full year, EBITDA was $887 million, and EBITDA margin was 27.2%. Both were records for the engines products teams, a significant accomplishment. 2023 EBITDA margin was up approximately 450 basis points from 2019 when revenue was at a similar level.

Now let's move to slide eight. Fastening Systems revenue increased 26% year-over-year to $360 million. Commercial aerospace was 45% higher, including the impact of the wide-body recover. Commercial transportation was up 13%. General industrial was up 8%, and defense aerospace was down 9%.

Year-over-year, EBITDA increased 38% to $80 million. EBITDA margin increased 180 basis points year-over-year to 22.2%. We are pleased with the continued performance of the fastening systems team with three consecutive quarters of revenue, EBITDA, and EBITDA margin growth.

Now let's move to slide nine. Engineered Structures revenue increased 6% year-over-year to $244 million. Commercial aerospace was up 19% driven by build rates and the wide-body recovery. Russian titanium share gain was flat year-over-year at approximately $20 million due to timing of shipments. Defense aerospace was down 35% year-over-year driven by the F35 and legacy fighter programs.

EBITDA was $33 million, down slightly from prior year. EBITDA margin decreased 130 basis points year-over-year to 13.5%, partially due to absorbing net new employees. However, sequentially, revenue, EBITDA, and EBITDA margin increased for the second consecutive quarter. In Q4, sequential revenue increased 7% and EBITDA increased 10%. Although production efficiencies are not yet back to targeted levels, we are making progress and expect continued recovery in 2024.

Now let's move to slide 10. Forged Wheels year-over-year revenue increased 3% to $275 million. The $9 million increase in revenue year-over-year was driven by an 8% increase in volume, partially offset by lower aluminum prices. Sequentially, volumes were down 3% as we're starting to see signs of the commercial transportation market softening. EBITDA was flat year-over-year. EBITDA margin decreased 90 basis points primarily due to the timing of inflationary costs pass-through.

Finally, let's move to slide 11 for more detail on debt actions. In the fourth quarter, we redeemed $500 million of our 2024 bonds. The $500 million redemption at par was funded with approximately $100 million of cash from the balance sheet and approximately $400 million draw from two term loan facilities. Both term loan are prepayable without penalties or premiums and mature in November of 2026. $200 million was drawn from a U.S. dollar-denominated term loan facility and approximately $200 million was drawn from a Japanese yen denominated term loan facility. We entered into interest rate swaps to exchange the floating interest rates of the term loans into fixed interest rates.

The weighted average fixed interest rate is approximately 3.9%, which is lower than the 2024 bonds coupon of 5.125% [ph]. The combined impact of these Q4 actions is expected to reduce annualized interest expense by approximately $10 million. Moreover, debt reductions in Q1 through Q3 reduced annualized interest expense by an additional $19 million.

We continue to leverage the strength of our balance sheet. Since 2020, we've paid down gross debt by approximately $2.2 billion with cash on hand and lowered our annualized interest cost by more than $130 million. Gross debt now stands at approximately $3.7 billion. All long-term debt continues to be unsecured and at fixed rates and our $1 billion revolver remains undrawn.

Lastly, before turning it back to John, let me highlight a couple of additional items. As we continue to focus on improving Howmet's performance and capital allocation, I wanted to highlight our pretax RONA, or return on net assets metric, RONA, which excludes goodwill and special items has improved by approximately 400 basis points on a year-over-year basis from 29% in 2022 to 33% in 2023. You will find reconciliations in the appendix of the presentation.

Lastly, in the appendix on slide 16, we have included 2024 assumptions. Interest expense is expected to improve to approximately $200 million. The guidance includes all debt actions completed to date. The operational tax rate is expected to continue to improve to a range of 21% to 22%. The midpoint of our guidance represents approximately a 600 basis point improvement in the operational tax rate since separation in 2020. We continue to be focused on further improvements in our operational tax rate. Pension and OPEB expense as well as contributions are expected to increase modestly by approximately $15 million year-over-year.

Finally, we expect miscellaneous other expenses, which are below the line to be in the range of $5 million of income to $15 million of expense for the year, but are very volatile within quarters.

So with that, let me turn it back to John.

John Plant

Thanks Ken, and let's move to slide 12, please. The commercial aerospace market continues to be strong. Airline load factors are good. International travel continues to strengthen and all this has led to significant orders for new aircraft and higher levels of aircraft backlog at both Airbus and Boeing.

Demand for new aircraft is expected to be sustained due to the need for aircraft with substantially improved fuel efficiency and also to the commitments made by airlines of improvement towards carbon neutrality with two stages of 2030 and then 2050.

Commercial aerospace spares are also growing not only due to the number of aircraft in service, but also in the case of narrow-body due to the increased service shop visit requirements of the newer fuel efficient engines. This is a long-term trend over the next decade and one which we look forward to.

Defense budgets and hence the defense market continues to be strong in fighter aircraft, farmers, drones and helicopters. Tank turbines and Howmet systems are also strong. Specifically, we expect increased F35 engine spare requirements due to the shop visit requirements as the fleet continues to expand globally. Other markets of oil and gas and gas turbines continue to be healthy. We do see natural gas turbines to be the natural accompanying technology to the renewal segment of wind and solar.

The market where we're cautious is that of commercial transportation, where we see potential for up to a 10% reduction in revenue as we move through 2024. We do envisage commercial transportation to resume growth in 2025 and into 2026. This is supported by the view that any potential reduction is mild due in part to the continued secular growth of our improved penetration of aluminum wheels compared to steel wheels for the needs of fuel efficiency or increased payloads. Also as truck engines move to alternate means of propulsion other than fossil fuels, the adoption of aluminum wheels should gradually move towards 100%.

Moving now from general market commentary to specific numbers. We expect Q1 revenue to be up 9% year-over-year and EBITDA up approximately 11%. For Q1 of 2024, we expect revenues of $1.74 billion, plus or minus $10 million, EBITDA of $400 million, plus or minus $5 million and earnings per share of $0.51 plus or minus $0.1. This is similar to Q4 after excluding the one-off benefits of the tax rate and below the line items, which contributed about $0.02.

Regarding the full year 2024, we see revenue at $7.1 billion plus or minus $100 million; EBITDA of $1.635 billion plus or minus $35 million; and earnings per share of $2.15 plus or minus $0.05. Free cash flow, we see a $735 million plus or minus $35 million and CapEx of $290 million plus or minus $15 million.

I'd like to comment further on the capital expenditures, seen as these are expected to be above depreciation for the first time in many years. Essentially, this is due to investment opportunities materializing the Engine Products business. We see this as a very good sign to be able to deploy capital with high returns and rapid future growth.

In fact, let me expand. In fact, 2023, which was another year of above market growth in each of our segments, in fact, above 5% above market served. This engine investment is viewed as excellent and speaks to the continued market growth in the business with 27%-plus EBITDA margins and a 33%-plus return of capital. And this continued growth is seen as the investments come on stream in approximately 18 months' time.

Underpinning all of this is an agreement with one of our engine manufacturer customers for increased business and increased market shares. This does not change our long-term commitment to deliver average free cash flow conversion of 90% of net income. And as you can see from our guide, free cash flow after all cost is approximately 45% of EBITDA which is best-in-class. We based our guidance on Boeing 737 MAX production of 34 aircraft per month and six 787 aircraft per month.

Our Airbus assumptions are in line with their plans. As an example, Airbus A320s are at 56 aircraft per month. We are prepared and can be prepared should volumes increase above current customer assumptions. In the case of the A320 we're anticipating the build rate increasing in 2025 to approximately 60 to 65 aircraft a month and that will require us to do some prebuilds or parts in 2024, and that explains the average we've given.

Please now move to slide 13. 2023 was another good year for Howmet. Sales increased by 17% and were above each of our segments end markets. EBITDA was up 18% and EBITDA margin increased to 23% in the second half of the year. Earnings per share was up 31%. Cash flow exceeded guidance and was in line with our long-term view of converting 9% of net income into cash flow. The balance sheet was strengthened with significant debt paydown repurchases with cash on hand and record low net leverage of 2.1 times.

The outlook for next year or for 2024 has already been outlined in the numbers given. But let me give you some qualitative terms to look at 2024 as it demonstrates the following features. We have further revenue growth, which we expect will be proven to be again in excess of our end markets served.

Free cash flow continues to improve with the higher EBITDA margins and we expect further reduced debt and interest expense burden. And we take into 2024 a reduced share count. And you can expect further shareholder friendly actions of increased share buybacks and further dividend growth.

And now I'll close my prepared remarks. I now hand over and get ready for questions. Thank you.

Question-and-Answer Session

Operator

We will now begin the question-and-answer session. [Operator Instructions]

Today's first question comes from Doug Harned with Bernstein. Please go ahead.

Douglas Harned

Good morning. Thank you. Hey, Doug. When you're looking at a situation with very high demand on the Engine Products side. And one thing I'm really interested is how you're seeing pricing. Given your very strong position there, you're looking at catalog spares prices from the engine OEMs up in the teens recently, what do you see for Howmet in terms of pricing over the next couple of years? And can you explain the differences there between what you're getting and what you're seeing is increases on the engine OEM side?

John Plant

Yeah. We've noted that our engine customers have been raising prices into the MRO shops significantly. We don't have that opportunity, Doug, in the short-term. In that our long-term agreements provide for price stability during the duration of those agreements. However, when we get to the long-term agreement renewal, with the sophistication of the analysis we introduced a few years ago, we now split all of the parts into volume and variety and looking at the different trends within that and also when parts go to, let's call it, past model and become service only, but also noting the increased service demand for even current parts.

And so at that time, we do differentiate between the increased pricing that we expect to receive at the LTA renewal and certainly look at the service requirements and the pricing and you can expect that as we renew those agreements, and I don't generally comment about when those agreements are renewed, but you can expect to see increased pricing associated with the service parts.

Douglas Harned

But from your standpoint, when you look at save in the short-term 2024. So, how do you think of your pricing relative to inflation? And is this a positive contributor to margins?

John Plant

No, I don't think you can say that we're going to price per se on an individual service part. But what you can expect is that we will be moving on price once again in 2024. And you'll see when we issue our 10-K, which I believe is this evening, you'll see that trend continued in Q4. So, I expect to see continued positive contributions from pricing as we go forward. And you'll see that '23 was a healthy year and '24 should be an equally healthy year.

Douglas Harned

Very good. Thank you.

John Plant

Thank you.

Operator

The next question is from Robert Stallard with Vertical Research. Please go ahead.

Robert Stallard

Thanks so much. Good morning.

John Plant

Hey, Rob.

Robert Stallard

Hey, John. On your Boeing 737 rate assumption, are you currently shipping at 34 a month to the 737 line? And if Boeing should actually get to 38, do you have the head count in place to sustain that? Thank you.

John Plant

Okay. So, we received demand signals from two principal sources. One is from, of course, the aircraft manufacturers for our structural products and then on a different sequencing, the demand signals from the engine manufacturers. If you look at 2023, we saw Boeing schedules increase to rate 38. And so, we were in a position and we're able to support them in that rate 38. We were cautious when they were talking about going up to 42, which as you saw was delayed and now that's not going to be the case. Our thoughts around 2024 is that this is going to continue to be choppy. And as the back class, it's not necessarily the stop start that we've experienced in quite the same degree as the last couple of years. But we're also prepared that maybe Boeing will not be building at rate 38 because indeed we don't believe that they have built at that rate, and we've seen various assumptions of what was actually built in Q4 and now we see they are restricted to -- by the FIA in terms of build in 2024.

What, of course, we don't know is to what degree of any under-build in one month will be low to overbuild in another month or indeed, is it just going to be capped at the production for that month in terms of issuance of airworthed [ph] certificates. We have no idea. And therefore, we're still thinking that demand could be choppy and indeed given the balance sheet of Boeing, is that are they willing to continue to sustain building out at a higher rate than the actually building. And therefore, we've made some allowance within our working capital such that if they don't take the parts or scheduled is that, that's provided for in the free cash flow guidance that we've given you.

And similarly, I mean, I'll get it all out there is that we saw our margin flow-through for 2024 at 28% plus or minus compared to our Q4 of 31%. And this also allowed to provide some allowance for the chop or choppiness that we may see, depending on how things go with Boeing.

Robert Stallard

That’s great. Thanks John.

John Plant

Thank you.

Operator

The next question comes from Peter Arment with Baird. Please go ahead.

Peter Arment

Thanks. Good morning, John and Ken.

John Plant

Good morning.

Peter Arment

John, you added, I think, roughly about 1,700 employees in 2023, if I have that correct. I was just wondering what your guidance kind of assumes around headcount growth expectations in '24. And yeah, maybe I'll leave it there. Thanks.

John Plant

Yeah. We were expecting between 1,000, 1,500 people depending upon what the exit rate should finally be for the year. So, we are continuing to recruit albeit from those numbers, you can see that we're ingesting the labor at a reduced net rate to the last year -- over the last 18 months. And some of that's to do with the bringing now the experience of some of those operators who've been able to retain during that recruitment process and also the improvement in productivity that again we are planning to make. And so, a blend of all of those things plus some of the automation that we've talked about in the past coming on stream. So, let's call it 500 people plus or minus less than we took on last year and while at the same time, trying to improve our recruitment and retention statistics, which is really very important to us to gain that further stability of labor.

Peter Arment

Thanks for that. Thanks John.

John Plant

Thank you.

Operator

The next question is from Myles Walton with Wolfe Research. Please go ahead.

Myles Walton

Thanks. Good morning. Hope to focus on Fastening Systems, if you could, John. The growth there obviously was pretty much on top of the Engine Products growth. Is there a leader in '24? Is it Fastening Systems? And then maybe just could you provide any color as it relates to where distribution sits with Fastening and where your wide-body recovery is versus pre-COVID?

John Plant

Yeah. And one of the things that I've been particularly pleased with has been the improvements in our distribution business inside Fastening Systems. A couple of years ago, maybe three years ago now, we created a separate business within H1 [ph] amalgamated with our OE business. We provided dedicated management to that distribution business. And we've seen it indeed have outsized growth relative to the market, and that continued again in a significant way in 2023. So that's proven to be very good for us.

In terms of like where does the final, I'll say, scorecard land for 2024 in terms of relative growth of Engine versus Fasteners, it's difficult to say at the moment, I expect very positive contributions from both. We have to recognize is that we still have to see wide-body demand come back and really be built with a propensity actually to grow higher because that wide-body demand mix should actually show improvements because the relative growth compared to narrow-body, especially given that Boeing is now capped is that, that should be good.

At the same time, we note -- for example, take the LEAP range of engines is that the -- I'll say, growth of that segment has been reduced a little bit, both in the actual for 2023 and slightly lower build as the initial demands have dropped from. I'll say, a year ago, we saw a '24 was going to be looking at 2,200 engines then went to 2000 and I know it's in the range of, I think, something like 1,875 to 1,950, something like that. So, we've got to see how all that settles out and indeed, it's a balance of what goes to OE build versus service demand for those engines. So, I mean, the most important thing is both Engine and Fasteners are good. So, I don't want to handicap it at this point, but it will be -- I expect that we'll be having a good year for both.

Myles Walton

Okay. Thank you.

John Plant

Thank you.

Operator

The next question comes from Sheila Kahyaoglu with Jefferies. Please go ahead.

Sheila Kahyaoglu

Good morning, guys. Thank you for the time.

John Plant

Hi, Sheila.

Sheila Kahyaoglu

I wanted to ask about margins. John, maybe you could talk about 2024 margins, just looking at Q1 and the full year, you're kind of pointing to 23%. And I guess I'm a little surprised that there's no really an improvement from your Q4 exit rate and you're still sub 30% on the incrementals. So, maybe if you could just shape that out for us, how you think about that with aero volumes getting better and maybe else troughing. And also, you mentioned something in the -- in regards to engine pricing and how you're locked into long-term contracts and as well as the F35, obviously, that's a long-term contract, too. So, how do you think about what percentage of your margins are locked in because of LTA?

John Plant

I mean LTA certainly govern the most of our business for the company. And I guess momentarily the number of how much is [indiscernible], but it's -- I'm going to say somewhere up at that. So I'm going to say 75% to 85%, I believe, but can one refine that should need to, as I carry on talking here.

Having said that, of course, there are certain agreements which have come up for renewal for 2024 pricing. And indeed, we are probably now 90% agreed for the price structures for 2024. And so, our expectation for the price commentary I've already given you is that you'll see that Q4 was healthy or mutual with 10-K, a very solid year and we expect 2024 to be similar. And within that, you will see some of our Engine Products to indeed be repriced during 2024 and have already been agreed. So that's also the good.

In terms of margins, I mean, you never get like quarter-on-quarter straight line, you tend to plateau for a little while and then you move again. And our thought really has been that we stepped up to a 23% level in the second half of '23. And so what should we expect? And I think you're saying, well, let's play it again for Q1 and see how we go is the right assumption. I've already told you that we have assumed a 28% incremental versus what we converted at 31% in Q4. And this also provides some allowance for the choppiness that I've commented on them. So should for example, Boeing not take all the parts that they've scheduled out and those have to go into inventory. Therefore, we won't be taking the profit on them. And so, we've assumed that, I'd say, a 3% lower absolute number of conversion. And therefore, to me, just playing it out seems a very reasonable assumption for the near term.

How it flows for the balance of the year? It's difficult to say at this point in time. In terms of up-to-date market commentary, we actually see wheels demand to be probably a little bit stronger than we had imagined in the short term, and that's within the numbers we've already given you. At the same time, what does the back end of the year behold? I don't really know at this point. Orders have been into take for -- truck manufacturers have been a little bit stronger. And therefore, it bodes well, but of course, those are cancelable depending upon how the general economy goes and we'll have to wait and see.

For me, the most important thing, it's not like what happens this quarter or next. But indeed, that market of commercial transportation, we expect to resume growth in '25 and '26 and then that continued with, I think, strong continued demand from commercial aerospace and then continuing to defense and for the gas turbine business promises good growth beyond '24 as we going to '25 and '26.

Sheila Kahyaoglu

Great. Thank you.

Ken Giacobbe

And Sheila, this is Ken. Just to build on your question around long-term agreements, right? John is right, somewhere in the 75% of the revenue is tied to long-term agreements. That could be plus or minus, say 5% depending on where we are in the renewal process. As you can imagine, on the aerospace side, much heavier on long-term agreements. So, on the engines side of the house, you could be up to 90% of that revenue, could be under long-term agreements.

Sheila Kahyaoglu

Great. Thank you.

Operator

The next question comes from Noah Poponak with Goldman Sachs. Please go ahead.

Noah Poponak

Hey, good morning, everyone.

John Plant

Hey, Noah.

Noah Poponak

John, just one clarification on the original equipment side of aerospace. I couldn't quite decipher where you're saying you are now on the MAX rate, if it's possible to quantify that?

And then on the aftermarket side, can you baseline us on what percentage of aerospace is aftermarket at this point? And just how much growth can we expect there in the medium term given the work you're doing related to time on wing on the engine and elsewhere that's incremental?

John Plant

Yeah. So, our assumption in terms of our guide -- of course, our guide is quite independent of what Boeing or indeed Airbus may build and what they may schedule, it's our financial assumption and one that I feel appropriate for Howmet. And for the large part, I feel is that we've tended to call the market fairly reasonably in the last few years. So, our assumption very clear was at 34% for the average for Boeing 737 for the year.

Now what they actually build, I don't know and what they actually schedule at. I'm going to say at the moment, they say they're going to continue with their rate 38 assumption as best as we can detect from what we see from our demand schedules. So that's those specific numbers.

In terms of spares, our exit rate for spares in the commercial aviation market, stepped up again. And so compared to 2019, which is the reference point we've used previously. And if you remember, in 2019 revenue from the spares market for -- on the commercial side is about $400 million, and it was about $400 million on the defense and gas turbine side. On the gas turbine and defense side, that continues to be steady and an increasing and now that increased to a level, we believe we'll see something like $600 million of demand in the defense sector and IGT sector. We're both growing but indeed, the spares for the F35 growing in particular. And in 2025, as an example, we expect the spares business for F35 to be as big as the OE business has been in recent years. So that's been good. We've seen demand increase in '23, we're expecting it in '24 and then '25. We should expect it to be a segment continue to grow as that fleet continues to expand. And the fleet, I think, is about 975 aircraft.

And while we originally thought it's going to expand at like the 150 a year, as you know, currently Lockheed is not building or not building nor delivering at that rate. And so, to some degree, you have to be a little bit cautious. But you can expect a 50% increase compared to 2019 levels.

In the case of the commercial segment, that did drop at the depths of COVID to half, so something just sub $200 million. And now that's fully grown back to $400 million, but with the run rate -- you see in the third and fourth quarters and then strengthening each quarter is that, that is now at a run rate above $400 million. And then obviously, to that, you also have to bake in the potential for additional schedules as these reported time on wing issues get, I'll say, addressed and serviced. And we do expect demand to be picking up in the second half of 2024 and then further strong demand -- a very strong demand going in '25 and '26. So that we see is very good. And so today, you can assume that our spares business for '23 is getting about, let's say, the $1 billion mark, and we expect it to be -- that is -- therefore, an increased percentage of our revenues and you could expect the percentage, therefore going into the aftermarket to continue to increase as we go into '25, '26 after a healthy year in '24.

So, overall, a good picture and indeed, as I said in my commentary, that the thing which is -- it's not demand just to solve the immediacy of a time on wing issue. I mean, there is a structural shift in spares demand, which I don't think it's appreciated yet totally in the newer engines themselves essentially have increased service intervals because as you increase the temperature pressure in engine, the wearing part, so I think the high pressure turbine part of the engine. So, those initial Blade 1, Blade 2, vane one, et cetera, those become a wearable or wearing parts, a bit like brake pads on a car. And so, you can expect to see a structural shift as increased fitment of those engines is in the fleet and it replaces the predecessor CFM56 engine. So, you're seeing temporary strong demand for CFM56 just to running the fleet at existing fleet harder and a fundamental structural increase in replacement costs which is going to be there. And I think you're going to see additional, say, service shops built around the work to service these new engines, but that's seen that will unfold over the next, say, few years.

Noah Poponak

Okay. That's really interesting. I appreciate all that detail. Just to make sure I have the MAX assumption correct, are you delivering to about 34 right now and you assume you stay there through the year? Are you in the low 30s right now, and you assume you actually click into that stated 38 without any rate breaks above and beyond that.

John Plant

So if I give you, let's say, the fourth quarter, we believe we delivered at rate 38, while Boeing build, let's say, rate 30. So, in Q4, let's assume that 8 aircraft sets per month went into inventory. So, there's 24 sets of parts which are sitting in Boeing inventory for the structural part, that our estimation.

I don't think it's just quite the same on the engine side. Because what wasn't built in engines, let's say, the reduced engine build, which you've already had commentary from the engine manufacturers about that then the balance of the majority of the part, certainly on the turbine side, but not necessarily on the structural side, essentially went into service parts delivery into the MRO shops to account for what I already just talked about.

Noah Poponak

Okay.

John Plant

And so if you think about it, assuming that Boeing taking Q1 at 38, depending on what the final thing is, then there is -- if they build up, my assumption is 34, maybe they'll bill at 38. That's why I've allowed for some choppiness as I already commented on, and allowed for some inventory that we may end up carrying as that gets ironed out and with how many people will recruit or we have already commented on that. And so, it's allowed for that, and it's allowed for some of that choppiness within the margin rate incrementals that I've given, calling out 28 versus 31 in Q4.

Noah Poponak

Okay. Super helpful. Thanks so much.

John Plant

Thank you.

Operator

The next question comes from Robert Spingarn with Melius Research. Please go ahead.

Scott Mikus

Hi. Scott Mikus on for Rob Spingarn. John, I wanted to ask you, the last time you had mentioned this, it was -- I believe you had 1.5 times the relative market share of your closest competitor in the airfoils market. So just with the upgrade to the GTF and then also thinking about the new engine agreement with an engine OEM customer that you referenced, where does your relative market share stand now in the airfoils market?

John Plant

Okay. We have grown about 1% share a year in the turbine airfoils market over the last, let's say, four or five years. And so, it's been a consistent march, and we believe we're just around that 50% mark currently. And we see that continuing to grow commensurate with some of the, I'll say, extraordinary levels of technology that we bring in that segment. And also I've commented here, we would not be considering, let's say, investing further in the scale that I've referred to, without knowledge of that share being there and indeed, I did say very clearly and unequivocally that we've also contracted additional share within that. So, we continue to drive that improve it. And as you did here, hopefully, is that's not changing our free cash flow guide metric, the conversion of net income.

Scott Mikus

Okay. And then as a follow-up, I wanted to ask, did you see any pickup in spot sales in 2023? And do you have any assumption for spot sales baked into the 2024 guide?

John Plant

Yeah. We did see the spot market pick up further in '23. You can never be sure. So, we've just assumed it's played again in 2024. And we did put in some security stock of material such that we could respond to the spot market and our balance sheet could take it. But we not assume that it's like a further significant step-up because it's also in that unknown area of indeed what hadn't been previously scheduled, what additional demands are there and sometimes the opportunity for an increased share if somebody else is not able to deliver. So, it's not an easy number to say. We assume that we're going to get more. I don't think that's a sensible way to plan.

Scott Mikus

Thanks for taking the questions.

John Plant

Thank you.

Operator

The next question comes from Seth Seifman with JPMorgan. Please go ahead.

Seth Seifman

Hey, thanks very much and good morning.

John Plant

Hi, Seth.

Seth Seifman

Good morning. If I could ask maybe a two-part question, just about all this 737 and just understanding that dynamic. You spoke, I guess, extensively about Boeing and the production rate there. Can you talk about at the -- on the engine side, and kind of where that level of production is expected to be in 2024? And then on the airframe side, how much -- I assume most of the 737 content on the airframe side is in fasteners? And I guess, so how much of that goes directly to Boeing versus how much would be going to other suppliers like maybe Spirit especially. And so that would imply that your expectation in terms of the demand pull for Howmet would be more -- not even necessarily a demand pull from Boeing directly, but the demand pull from the, let's say, Tier 1 in the Boeing supply chain.

John Plant

Yeah. So, we do supply, I going to say, in terms of commercial -- for Boeing's requirements, we supply the majority directly to Boeing. But we also do supply Spirit as an example and others that are also providing subassemblies to Boeing. And so again, it's never an absolutely clear picture. But we just assume like we've taken an assumption of a number of aircraft sets. It could be that Boeing build at one level. And maybe another supplier might build at a different level, and it's also compared to what they want to hold and also indeed what Boeing have by way of their minimum, maximum inventory holdings as well. So, we operate on a min-max system, just roughly correlated to build, but as times when it breaks that correlation.

So, it's never quite straightforward, Seth, I don't want to burden you is, I'll say, unnecessary detail, but the best assumption is just we've based that on 34 and all of the other suppliers of rate 34 and knowing that at some point, that if Boeing have been scheduling at a higher rate and build the inventory has to come out and so there be held because there's going to be -- maybe the rate assumption will go up, maybe it will be 42, maybe be 47 in 2025. And therefore, because it's really important that all the parts are there, so you avoid traveled work, which has been set a lot of commentary recently. So having supply security and all the parts available is really important. And therefore, it could well be that all of that will be held, which we don't know that. And at the same time, there's also the possibility is that given the cash strain that either Boeing or other suppliers may be under is that they will adjust inventory.

So, we've just taken that cautious view, prepared that against -- for example, against the conversion of straight 90% of net income, which is a long-term guide. You can see from what we've given you this morning, it's like 85% plus or minus and that provides the allowance for just in case we have not only the growth rate that we expect, but also if we get caught holding the having to hold the bag in terms of a little bit lower take the natural schedules as some of those MAX inventories are adjusted. We don't know that. It's just an assumption. I mean clearly what we hope for is that they build fully and at great quality levels of rate 38. That's what we want. That's what we hope for. We look for great success from our customers. We'd love to see that. And should they build and schedule and then increase schedules for an increase in rate in 2025 then that will be really good for us. And you could expect us to be further increasing our sales should those scenarios play out. But at the moment, we're not prepared to go there because we don't know.

Seth Seifman

Great. Thanks very much.

John Plant

Thank you.

Operator

The next question comes from David Strauss with Barclays. Please go ahead.

David Strauss

Thanks. Good morning.

John Plant

Hi, David.

David Strauss

So, John, I guess, following up on that. So, if I take 5% on the free cash flow conversion, it looks like it's about $50 million that you have assumed in working capital or inventory build related to conservatism around what Boeing takes. But even with that, it looks like or I guess on top of that, it looks like you've got maybe $100 million, $150 million of working capital usage in that free cash flow guidance. Is that correct? And if so, what is that?

And the other part of the question is capital deployment. I know you don't have anything baked in, but how are you thinking about that given -- I know you have $200 million you've got left to retire this year, but that -- given the cash guide gives you a fair amount of room to use coming on the share repurchase side. Thanks.

John Plant

Yeah. So, you can -- it's always these multipart questions, which we get here. So, first of all, of course, given that revenues are increasing, let's call it $0.5 billion in the guide, there is a natural 15% to 20% working capital drag on that. So, let's use the 20% because the math becomes so much easier. There's $100 million of working capital for you to which we added the sort of number that you talked about in terms of that propensity which might happen. So that's where we are on that assumption.

And in terms of how we deploy, we haven't actually fixed anything at this point, but it's hardly likely that we're going to enter a refinancing for a couple of hundred million. So, it's quite possible that we may decide just to retire that and take those interest rate savings into, let's say, end of the fourth quarter and into 2025. And therefore, you can assume that's all we're going to do probably. I mean, we could do a bit of a refi around the '25s, that's on a TBD basis, but that's not going to be a big drag either which way a platform any fee structure and breakage cost. But then the majority then you can assume it's going to be share buyback. So position all wise, you can assume that 2024 will be a bigger year for share buybacks compared to 2023 where you can see the majority of the action was further on the debt side to put our balance sheet into the great shape that it's currently in. And so, roughly speaking, you can assume further leverage improvements despite the share buyback thoughts that we have at the moment, which are going to be elevated compared to 2023.

David Strauss

Great. You got both parts. Appreciate it.