Honeywell International Inc HON | ★★★★ Brian Bernard, CFA, CPA - Sector Director - Morningstar Inc.

Honeywell's Security Acquisition Will Augment Growth in 2024-25

by Brian Bernard
Sector Director
Morningstar Inc.

Authors can be reached at
Analyst Feedback

Analyst Note
Honeywell Earnings: Mixed Q4 Results but Progress Toward Long-Term Financial Targets Continues
by Brian Bernard, 01/02/2024

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Honeywell's shares traded lower on Feb. 1 after the wide-moat firm released its fourth-quarter and full-year 2023 results and provided 2024 guidance. Fourth-quarter revenue grew 3% (2% organic) to $9.4 billion, segment margin expanded 60 basis points to 23.5%, and adjusted EPS increased 3% to $2.60. While adjusted EPS came in $0.01 above the FactSet consensus estimate, revenue fell about 3% shy of consensus, and management's 2024 revenue outlook of $38.1 billion-$38.9 billion fell short of the $39.0 billion consensus expectation.

Performance across Honeywell's legacy segments was mixed. Recall the firm will report re-segmented results in fiscal 2024. Aerospace organic revenue increased 15% year over year and segment margin improved 20 basis points to 28% amid strong commercial aviation original equipment demand and solid growth within defense and space. Building technologies' organic revenue slipped 1% and segment margin contracted 90 basis points to 23.9% as weaker demand for short-cycle building products and cost inflation more than offset solid demand for long-cycle building solutions and productivity initiatives. The performance materials segment delivered 4% organic growth with 200 basis points of margin expansion (to 24.0%) as demand was solid across end markets and profitability benefited from favorable mix and productivity gains. Safety and productivity solutions was the laggard during the quarter, with organic revenue down 24% and segment margin 290 basis points lower to 17.3%. Management said warehouse automation project volumes remain in the doldrums. Nevertheless, we remain bullish on Honeywell's long-term prospects in warehouse automation.

Looking ahead to 2024, management sees 4%-6% organic sales growth, 30-60 basis points of segment margin expansion, 7%-10% adjusted EPS growth, and free cash flow of $5.6 billion-$6.0 billion. We maintain our $229 per share fair value estimate, but we will revisit our model assumptions after the firm's 10-K is filed.

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Business Strategy and Outlook 19/12/2023

Honeywell is one of the strongest multi-industry firms in operation today. We think the company has successfully pivoted to capture multiple ESG trends, including energy efficiency, emissions

Morningstar's Take HON

Price 20/02/2024	Fair Value Estimate	Uncertainty
198.94 USD	229.00 USD	Medium

Economic Moat	Cost Allocation	Financial Strength
Wide	Exemplary	A

There is no one analyst in which a Quantitative Fair Value Estimate is attributed to; however, Mr. Lee Davidson, Head of Quantitative Research for Morningstar, Inc., is responsible for overseeing the methodology that supports the quantitative fair value. As an employee of Morningstar, Inc., Mr. Davidson is guided by Morningstar, Inc.'s Code of Ethics and Personal Securities Trading Policy in carrying out his responsibilities. For information regarding Conflicts of Interests, click here.

Bulls Say

- Honeywell is making several organic bets in mission-critical end markets that should yield triple-digit IRRs over the long term, including in quantum computing and building automation.
- Honeywell boasts one of the strongest balance sheets in the multi-industry universe, and it has a history of underpromising and overdelivering on its targets.
- With safety and productivity solutions seeing a meaningful drop in sales in 2023, this will meaningfully help margins because of positive mix, and allow SPS to eventually hit 20% operating margins.

Bears Say

- Honeywell trades at a considerable premium to its sum of the parts, and the stock price is a crowded trade that bakes in a lot of optimism and requires near-perfect execution to justify its assessment.
- Honeywell's large organic bets like quantum computing or its partnerships with SAP are promising, but won't move the needle in the medium term, which poses problems amid rising interest rates.
- Over half of Honeywell's portfolio is exposed to a short-cycle recession.

reduction, and e-commerce, among others. We predicate our long-term thesis on increased demand for warehouse automation solutions, despite tough 2023 comps; new digital offerings that promote data analytics in powerplants, as well as remote security management, and energy savings in building solutions; and the broader commercial aerospace recovery. Over the next five years, we think Honeywell is capable of mid-single-digit top-line growth, incremental operating margins in the high-20s to low-30s, between 9% and 10% adjusted EPS growth, and free cash flow margins in the midteens.

We believe Honeywell is capable of meeting our assumed targets through a combination of portfolio refreshes, powerful new product introductions, breakthrough initiatives, and strategic partnerships in areas where the firm has domain expertise, a focus on high-growth regions that'll help the firm grow faster than its core markets, continuous improvement initiatives centered on fixed cost reduction, on-time delivery and simplified design, supply chain automation, and an increasing shift toward software with a recurring revenue stream. In our view, Honeywell was wise to continue investing aggressively during the height of the pandemic, which we think will eventually reward the firm with share gains.

Despite appreciable near-term headwinds due to customer warehouse overbuilds, we believe COVID-19 only accelerated the need for automation given the strong secular trend toward e-commerce. Many of Honeywell's automation solutions offer customers meaningful return on investment from greater productivity. Furthermore, we think Honeywell is strongly positioned to lead in carbon capture, given its large installed base and investments in solvents.

Finally, we like that Honeywell is reorganizing its portfolio among its most important secular trends in aerospace, automation, and the energy transition. We think this will drive more focus in operations and better capital allocation decisions.

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Economic Moat

We view Honeywell as one of the highest-quality companies in the diversified industrials space and assign the firm a wide economic moat. We attribute this rating primarily to intangible assets and switching costs. Over a normalized cycle, which includes 10-year historical figures and our explicit five-year projections, we estimate that Honeywell earns about a 18% to 19% return on invested capital, inclusive of goodwill, or about 9 percentage points above our weighted average cost of capital of 8.5%. Furthermore, in none of these historical years, including the global financial crisis in 2008 nor the pandemic-induced recession of 2020, did Honeywell's ROIC ever fall below our estimated cost of capital. As such, we have a high degree of confidence in Honeywell’s ability to generate excess returns 10 years into the future, and believe it is more likely than not it will continue to do so 20 years into the future.Key to Honeywell carving a wide moat, in our view, is the firm’s increasing ability to leverage its software technology across its massive industrial installed base. This software technology is integrated into both mission-critical operations, as in cockpit control during commercial aircraft flights, and in customer operations, through diverse offerings like warehouse automation in factories or connected solutions in buildings.In our opinion, aerospace is Honeywell’s widest-moat business, both from a qualitative installed base perspective, and from a quantitative returns-based perspective.Importantly, the segment has maintained outperformance even through periods of top-line contraction, which increases the confidence in our rating. Furthermore, Honeywell boasts one of the largest installed base in the industry, including over 36,000 auxiliary power units, 25,000 engines, 20,000 wheels and brakes, 20,000 flight management systems, over 100 connected offerings, and over 10,000 units of satellite communication hardware. Aerospace is traditionally a razor-and-blade model. To beat competitors selling the razor and ultimately add to the installed base, Honeywell relies on its intangible assets. Specifically, these include superior technology, know-how, its long record of success, customer relationships, and to a lesser extent, patents. We think its superior technology stems from research and development, which we estimate represents about 4.5%-5% of the segment's sales, is appreciably larger than at most other diversified industrials across our coverage (which on average, spend about 2%-3% of sales).Honeywell's R&D expense as a proportion of sales, however, undersells the benefit Honeywell derives from R&D endeavors. The firm also gets a lift from its government relationships, primarily with the U.S. government. We consider the U.S. government relationship vital when coupled with Honeywell's long record of success, such as its historic contributions to American spaceflight. The U.S. government typically adds an additional 50% to the firm's R&D investment, funding Honeywell's total spend of just over 7% of its annual sales. In other words, Honeywell gets the sales benefit from this research without having to incur the additional expense. Because of its R&D efforts and technical know-how, Honeywell has virtually shut out other competitors in awarded contracts for avionics (aviation electronics), auxiliary power units, and mechanical systems (for example landing gear) since 2013. Between 2008 and 2017, Honeywell captured a 35% increase to its aircraft installed base. From 2018 to 2022, the firm anticipates it will have 2.7 times the amount of avionics, 2.1 times the amount of auxiliary power units, and 1.5 times the amount of mechanical systems on new aircraft deliveries relative to its competitors, based on awarded platforms.Relatedly, switching costs are strongly associated with higher-margin aftermarket sales. Aftermarket sales can broadly be broken down into two subcategories—the conventional aftermarket, the blade in the razor-and-blade model, which is tied to traditional flight-hour service contracts for maintenance, repair, and overhaul—as well as decoupled offerings, which break away from the traditional razor-and-blade model and relate more to discretionary spending customers make for aircraft upgrades. For either model, we think Honeywell benefits from switching costs given its equipment's strong integration into customers' airframes and landing systems. For the conventional aftermarket, the additional installed base has allowed Honeywell to have 30% more content per aircraft, and an increased share of maintenance service contracts, providing the firm with an annuitylike revenue stream. The firm's decoupled offerings have high switching costs given they perform tasks associated with a high cost of failure. These include in-flight health monitoring via satellite communication and landing assistance software. We think performance materials and technologies, or PMT, is another wide-moat segment. We think this segment benefits both from intangible assets thanks to superior technology, regulatory barriers, and intellectual property, as well as switching costs from recurring revenue in aftermarket services. PMT is a mix of three business lines with large installed bases, including universal oil products, or UOP, which sells catalysts and adsorbents to the oil and gas industry, process solutions, which sells industrial software solutions, and advanced materials, where it sells fluorine products like its Solstice molecule, as well as chemicals and polymers. The firm's acquisition of Elster, which partially folded into PMT in 2015, for example, gave it access to 200 million utility metering modules in portions of the U.S. and Europe, deployed over 10 years prior to its IPO in 2010. Honeywell is rapidly transforming this industrial installed base and overlaying it with software and data analytics on the heels of energy efficiency initiatives and mandates. We suspect that this will benefit Honeywell by allowing it to stay a step ahead of its competitors through enhanced visibility over its installed base. Our best quantitative evidence of switching costs from the segment's installed base, given its exposure to the oil and gas industry (at nearly 50% of revenue), is its ability to turn a profit even during large drops in the price of oil. During 2015-16, segment profits grew 14% even as the price of oil dropped by 55%, all while PMT maintained larger margins than peers. For the segment's intangibles, we think the forest matters more than the trees, but believe the Solstice molecule represents a good example of the firm's know-how and research and development efforts put into practice. This is a duopoly business with Chemours. The Solstice molecule is a chemical compound used in a variety of cleaning and aerosol applications—specifically medical, metal, and electronic applications—that complies with high safety and environmental standards but is as effective as hydrofluorocarbons. Moreover, Solstice remains a liquid for an extended period compared with alternatives, given its low boiling point but high heat of vaporization. Additionally, the Solstice molecule's unique properties give it a low surface tension but a high degree of solvency, allowing it to clean tight spaces. Importantly, it is the only U.S. Environmental Protection Agency-approved product designed for use in machine flushing operations in HVAC and refrigeration cleaning. While this product may seem imitable given sufficient resources, according to Reuters, Honeywell began developing HFC alternatives as far back as 2000 and committed $900 million total to this research effort. The environmental impact is also minimal relative to HFCs, with a global warming potential of less than 1 versus 1000 for HFCs. As for the building technologies segment, we believe it merits a narrow moat. We think the same moat sources are at work with a connected installed base created by intangible assets like superior technology offerings, valuable relationships with contractors, and a well-regarded reputation from over 100 years of operations, followed by recurring revenue on the heels of aftermarket service requirements indicating switching costs. Additionally, building technologies has moved away from single product sales to an ecosystem of smart commercial products. Unlike winner-takes-all markets, we believe the commercial device market is one where a few players can thrive playing in the same sandbox. Honeywell's building technologies integrates functions with high risks of failure, like security and fire monitoring, with other critical business operations, like energy usage and climate control. These solutions have the added benefit of alerting customers in the event of occurrences like power outages or maintenance needs, which provide the segment with additional recurring revenue (for example alarm monitoring or service dispatch in the event of alarm).Additionally, we think safety and productivity solutions, or SPS, has a narrow moat, even as we believe it offers the conglomerate the most promising sales growth prospects. While we see the same moat sources in play as in the rest of Honeywell's segments, we assign a narrow-moat rating because just over half of SPS' revenue base is in new markets with a less certain future, given earlier life cycles; and service revenue only constitutes about 6% to 7% of segment revenue (compared with a low-20s percentage mix for HBT and PMT, or 40%-plus for aerospace). These early-cycle products and services include the firm's warehouse automation offerings, for example. Specifically, warehouse automation refers to automating a variety of aspects of repetitive and error-prone operations, from storage and retrieval to software systems. Warehouse automation is one of the last frontiers where companies can significantly reduce their long-term manufacturing costs. According to St. Onge, only about 5% of warehouses are automated in the United States. This market is still fragmented but is increasingly consolidating, and we're convinced Honeywell strengthened its competitive position and will remain on top with its acquisition of Intelligrated, a top robotics company that fits well with Honeywell's previously limited handheld and voice recognition portfolio. The other portion of the SPS includes more old-world products, which we consider moatier given their comparably greater history of excess returns, including personal protective equipment and high-risk safety equipment that depends on intangible assets—specifically, brand recognition and a reputation for reliability.

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Risk and Uncertainty

We assign a Medium Morningstar Uncertainty Rating to Honeywell, with a greater level of uncertainty to the upside, given the firm's increasing exposure to software offerings. Raw material inflation can have an impact on its cost inputs, which may be difficult to offset with increased pricing in certain markets. Aerospace is a long-cycle business that can have a prolonged downturn period depending on global demand for air travel, as well as military defense spending, which can face headwinds like sequestration threats in the U.S. Home and building technologies faces headwinds in the event of a slowdown in global residential and commercial construction, and performance materials and technologies faces similar prospects with downturns in the oil and gas market. That said we're less concerned about normal ebbs and flows of the macro environment, given that Honeywell's business is split 60/40 between operating expenditure and capital expenditure cycles.In SPS, the biggest concern we have includes rapid changes in technology, which can obviate the impact of some of Honeywell's software investments and translate into diminished returns on capital projects relative to the firm's expectations. In the near term, the biggest risk is the fallout related to the global coronavirus pandemic on Honeywell's aerospace business, as well as the drop in the price of oil per barrel to well below what we saw in the industrial recession, and its effect on Honeywell's PMT segment.Environmental, social, and governance risks include legacy site environmental liabilities, asbestos liabilities, a Foreign Corrupt Practices Act investigation by the U.S. Department of Justice related to UOP's former third-party contractors in their dealing with Petrobras, and any potential embargo from the sale of defense systems. Of these, we think the biggest risk comes from asbestos and environmental liabilities, but these are known and baked into all three scenarios of our model.

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Capital Allocation

We assign Honeywell an Exemplary Morningstar Capital Allocation Rating based on its sound balance sheet, exceptional investments, and appropriate shareholder distributions. The firm has one of the strongest balance sheets in our coverage, with a net debt/EBITDA level that typically runs about 1 times. Second, we commend management for making promising growth capital expenditures investments at the height of the pandemic to take share from competitors. We expect the firm will earn significant economic profit from these investments. Finally, we like management's disciplined M&A process and its unwillingness to overpay for growth.We think CEO Vimal Kapur is well suited for the role given his decades-long track record of success in increasingly important positions of responsibility within Honeywell's portfolio, including leading the building technologies and performance materials and technologies segments. We think he'll work to refocus Honeywell's portfolio among its most important secular growth trends in the energy transition, automation, and aerospace.Prior to becoming CEO, Kapur was named COO, a move that was initially said to free up former CEO Adamczyk's time to contemplate M&A, but aside from the $1.3 billion agreement to purchase quality management software provider Sparta Systems back in late-2020, it really hadn't done much in the way of M&A. That changed with the $670 million acquisition of Compressor Controls Corporation in 2023. We concede that evaluating portfolio changes isn't always abundantly clear to the market and that prices haven't always been favorable. However, we would have thought Honeywell could have taken advantage during the pandemic-related selloff to deploy more capital, particularly in smaller bolt-on deals. Broadly speaking, however, we agree that not lowering the company's hurdle rates is the right move.Kapur certainly has his hands full getting Honeywell back to its normal growth algorithm given some operating headwinds, particularly with slowing near-term growth in building technologies, negative near-term growth in safety and productivity solutions, particularly related to warehouse automation, and to a lesser extent, the impact of supply chain disruptions on aerospace margins, though those appear to be abating. Warehouse automation is clearly resetting from the pandemic-related e-commerce tailwinds, so over the long term, we expect a return to growth.We continue to speculate that GE and Honeywell may one day consider merging some portion of their aerospace portfolios to combat the likes of Raytheon Technologies and others, but we think antitrust could become a stumbling block in that regard as it did in the early-2000s in Europe.

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Overview

Profile: Honeywell traces its roots to 1885 with Albert Butz's firm, Butz-Thermo Electric Regulator, which produced a predecessor to the modern thermostat. Today, Honeywell is a global multi-industry behemoth with one of the largest installed bases of equipment. It operates through four business segments: aerospace, building technologies, performance materials and technologies, and safety and productivity solutions. In recent years, the firm has made several portfolio changes, including the addition of Intelligrated in 2016, as well as the spinoffs of Garrett Technologies and Resideo in 2018. In 2019, the firm launched Honeywell Forge, its enterprise performance management software solution that leverages the firm's domain expertise in buildings, airlines, and critical infrastructure.

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Financial Strength: We think Honeywell operates from a very strong financial position and believe its credit risk is very low. Honeywell boasts one of the lowest net debt/EBITDA ratios of any of the U.S. multi-industry firms we cover at 1.2 times at the end of 2022, though prior to 2020, that figure has been at or below 1 times since 2012. In fact, we credit its balance sheet strength as one of its greatest assets during the pandemic as it was allowed to maintain its growth capital expenditures plans while other competitors froze growth capital expenditures spending in 2020. Furthermore, Honeywell's interest coverage ratio (EBIT/interest expense) stood at 15.5 times as of the end of 2022, meaning Honeywell has ample firepower to service its interest payments. Finally, Honeywell's pension and other postretirement benefits have a minimal effect on our fair value, as its pension is overfunded, and its other retiree benefits deduct a mere $0.15 per share from our fair value estimate.

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Brian Bernard, CFA, CPA - Sector Director - Morningstar Inc.

Fair Value is derived from a detailed projection of a company's future cash flows. Analysts create custom industry and company assumptions to feed income statement, balance sheet, and capital investment assumptions into a proprietary discounted cash flow modeling template. Scenario analysis, in-depth competitive advantage analysis, and a variety of other analytical tools are used to augment the discounted cash flow process. Combining analysts' financial forecasts with the firm's economic moat helps us assess how long returns on invested capital are likely to exceed the firm's cost of capital. Because we are modeling free cash flow to the firm—representing cash available to provide a return to all capital providers—we discount future cash flows using the weighted average of the costs of equity, debt, and preferred stock (and any other funding sources), using expected future proportionate long-term, market-value weights. If our base-case assumptions are true the market price will converge on our fair value estimate over time, generally within three years. Investments in securities are subject to market and other risks. Past performance of a security may or may not be sustained in future and is no indication of future performance. For detail information about the Qualitative Fair Value, please click here.