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Safran Building Toward Better Days

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Summary

- The launch of new LEAP engines and increasing maintenance needs for the older CFM engines should help drive good revenue growth and margin improvement for the propulsion business.
- Improving the aircraft equipment segment should be a high priority, and M&A may be a path to consider as a deal for Meggitt could offer meaningful synergies.
- Safran looks undervalued, but there are risks tied to future aircraft build-rates/deliveries, future aftermarket trends, and management's ability to improve margins.

It hasn't been the smoothest ride for aerospace companies, but France's **Safran** (OTCPK:SAFRY) is nevertheless worth a closer look. Safran is a tier one supplier in the aerospace market, and through its alliance with **General Electric** (NYSE:GE), a leading player in narrowbody aircraft engines. While the launch of a new engine program will pressure margins in the short term, aftermarket sales should start improving and management seems focused on removing the company from underperforming business lines.

The sale of the security business is going to bring a lot of cash to Safran and there are still concerns about what management will do with that money. Although management hasn't sounded particularly eager for M&A, and there aren't many deals out there that would seem to really improve the company, the Street is still batting around various names as potential targets. While this potential M&A is a significant swing factor, mid single-digit revenue growth and improving margins can drive a fair value more than 10% better than today's price, making these shares worth a closer look.

Investors/readers should note that Safran's ADRs are rather liquid, and while the home exchange shares are even more liquid, there should be adequate liquidity with the ADRs for most investors' needs.

A Major Player In Propulsion

Safran probably isn't a household name to most American investors but it is a top-tier supplier to the civil aerospace industry and a credible player in the defense industry as well.

Propulsion generates more than half of Safran's revenue, and the company is a leading player in the narrowbody engine market. Through a joint venture with GE, the two companies developed the CFM56 engine, a leading narrowbody engine with an installed base in the neighborhood of 28,000 engines. The CFM56 is the exclusive engine for the **Boeing** (NYSE:BA) 737 and has more than 50% share on the **Airbus** (OTCPK:EADSY) A320, and the two companies have developed the LEAP as the successor to the CFM.

The LEAP, for which Safran designed the low-pressure turbine, fan, and booster, offers 15% fuel savings over the CFM56 and lower emissions. Although it is very early days, market share has thus far shaped up north of 60%, with sole-source status on the Boeing 737MAX and **Comac** C919, and just over 50% share on orders to date for the A320neo. Early deliveries will be at a loss, which is typical for the industry and an issue for other aero suppliers like **Honeywell** (NYSE:HON) and **Meggitt** (OTCPK:MEGGY), but management believes that it can drive significant average cost reductions through 2020, and about 85% of the parts are double-sourced (and about 80% of the supply map overlaps with the CFM56).

Safran is also looking to establish a better trajectory for aftermarket business with the LEAP. Although management has revised expectations lower for the percentage of engines sold under long-term service agreements (from 80% to around 50%-60%), that's still better than the 20% of the CFM platform. Aftermarket sales are a tremendously important source of revenue and margins for most aero component suppliers, so this is encouraging for future profits. To that end, I'd also note that about 60% of Gen 2 CFM engines haven't had their first major maintenance cycle yet, so that represents a future potential source of revenue and margins.

All told, Safran's propulsion business is solid. GE and Honeywell enjoy better margins, but greater future aftermarket sales should improve margins for Safran (as should earning back launch costs for the LEAP and moving past Silvercrest costs). What's more, relative to **United Technologies** (NYSE:UTX), **Rolls-Royce** (OTCPK:RYCEY), and **MTU**, Safran has little to apologize for.

Narrowbody aircraft is the majority of the propulsion business, but there are other aspects to consider. The company's Silvercrest program, a small business jet engine, was its first attempt to develop a civil aerospace engine outside the GE alliance. While it has been selected for the **Dassault** Falcon 5X, it has had its challenges and the company wrote off capitalized R&D back in late 2015.

Safran is also a player in helicopter propulsion, with more than one-quarter market share (ahead of UTX and GE), but this is a challenging market and likely not a major (or at least reliable) growth driver. Safran also develops military engine systems (about 10% of the business), with its engines on the Mirage 2000 and Rafale, and propulsion systems for satellites, launch vehicles, and missiles through an alliance with Airbus (Airbus Safran Launchers).

Last but not least, Safran has a minor presence in widebody propulsion through partnerships with GE, including a 24% stake in the GE90 and a smaller stake in the GE9X. At this point, I do not believe Safran is looking to become a larger player in widebody engines, and given the problems/challenges in the widebody market that looks like a good move.

Other Systems Need Work

About a quarter of Safran's revenue has historically come from aircraft equipment, split between landing/braking systems (about half), electrical systems (about 30%), and engine systems. Boeing and Airbus are major customers for most of these segments (about 75% of landing/braking revenue and 90% of electrical), but business jets also factor into the mix. This has been a weaker business for Safran, with margins in the single digits, as it has a lower aftermarket mix and there has been a long-standing issue with under-used capacity (due at least in part to lower deliveries for major programs like the A380).

Safran is the leading player in landing gear structural units (ahead of UTX), and a significant player in landing/braking systems with UTX and Safran basically co-leading the segment (and Honeywell and Meggitt both close behind). Within the engine systems business, Safran has over 20% share in nacelles and over 30% share in business jet nacelles.

Defense makes up the rest of Safran's ongoing business. The defense business is mostly avionics (50%) and optronics (40%), but there is also a smaller business in electronics and software.

Security has been a part of Safran's business mix for a while, but Safran is selling the Morpho detection business to **Smiths** and the Morpho Identity and Security business to **Advent Intl**. These sales should bring in more than $3 billion when they are completed in 2017.

Where Does Safran Go Now?

To some extent, Safran is now in a "build it… and wait for them to come" part of its cycle. The LEAP engine should see increasing sales in the coming years as new programs at Boeing and Airbus ramp up. While there have been growing worries about future widebody aircraft deliveries, the narrowbody market is still looking comparatively healthier; there are no guarantees that future deliveries won't disappoint, but there's nothing Safran can do about that.

In the meantime, Safran is trying to better control what it can. Selling the security business brings in cash and takes out a collection of businesses that really didn't have much synergy with its other operations. Safran is also doing what it can to try to improve its aftermarket operations, but there are challenges here to consider as well. Aircraft retirements create a competitive supply for parts and Safran hasn't historically done a great job of getting engine customers under long-term aftermarket contracts. Improving this can be a major driver for improved margins in the future.

There is also a lot of room to do better outside of its business through the GE partnership. I don't believe the Silvercrest program proves that Safran can't succeed apart from GE, but management needs to demonstrate that it learned its lessons from this experience and won't repeat the same mistakes. In the equipment business(es), single-digit margins aren't going to get the job done and I'd like to see management do better here in terms of margins and aftermarket sales.

Improved supply chain and manufacturing efficiencies are one potential target, but winning more business and better leveraging its existing operations would likewise be a good outcome. With both the French government and employees owning meaningful equity stakes, I don't think hack-and-slash headcount reductions are going to be a preferred path toward better margins.

A major unknown with Safran's future direction is what happens after the security business sales are complete. Management has talked of a basically empty M&A pipeline, but the Street has been speculating on potential matches for some time. **Zodiac** (OTCPK:ZODFY) is a popular target, and it would take Safran into new markets (aircraft interiors), but Meggitt has also been floated as a potential idea. There could be some limited antitrust issues with Meggitt, but at least superficially, this seems like a match that could drive better long-term synergies.

The Opportunity

I'm not modeling a deal for either Zodiac or Meggitt, but I do model in the sale of the security businesses as a done deal. I'm looking for long-term revenue growth of around 5%, with greater growth in the next three to five years on the ramp up of the LEAP and relatively steady growth thereafter from both original equipment deliveries and aftermarket sales.

As the company moves past the considerable costs of the LEAP launch, sees more CFM engines come into their maintenance cycle, and improves the aircraft equipment segment, I see the potential for cash flow margins to expand into the double digits, supporting mid-teens free cash flow growth. If the aftermarket business disappoints, or if the new programs that the LEAP engines are attached to disappoint, there would definitely be downside risk.

Discounted back, I believe Safran shares should trade in the mid-EUR 70s, or about 10%-15% higher than they do today. While today's price works back to a roughly 9x forward EBITDA multiple (not exactly cheap), I expect EBITDA to accelerate meaningfully from 2017, so I don't believe investors should look at the multiple without also looking at the potential/likely growth in EBITDA.

The Bottom Line

Uncertainty about M&A and worries about future narrowbody deliveries are meaningful risk factors. I would suggest those concerns are at least part of the reason why these shares may be undervalued today. That said, this company has a pretty good history of improving margins and I like the company's market-leading position in civil narrowbody engines and the potential to improve its aftermarket operations and its aircraft equipment business. With that, I think Safran shares are at least worth a closer look for investors interested in the aerospace sector.

Disclosure: I/we have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours.

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