

COMPANY: Boeing	EPIC: BA.N	MARKET CAP: \$55.2bn	RECOMMENDATION: Buy Initiating Coverage	RISK RATING: 6 CATEGORY: UNRESTRICTED (see bottom of note for risk categories)	PRICE: \$74.63
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Boeing is one of the world's leading aerospace and defence companies, with total revenues in 2010 of \$64bn. It is divided into two main operating divisions: Boeing Commercial Airplanes (53% of 2011 revenues) and Defense, Space & Security (47% of 2011 revenues).

Investment Case

- Exposure to secular theme of growing air travel.
- High revenue visibility with production essentially sold out for five to six years.
- Strong production rate growth to meet demand and increase profitability.
- High-risk 787 development phase passed, versus EADS just entering it for the A350.
- Right product portfolio with 787 and 737 MAX.
- Consensus defence estimates are pricing in high negative growth in US spending.
- Strong free cash flow generation.

Boeing is currently trading at 15.3x consensus 2012 earnings and 12.8x consensus 2013 earnings, a premium to its commercial aviation comparatives and its defence comparatives. We believe that the premium is justified given the stage that Boeing is at in terms of the ramp-up of production in commercial airplanes and the potential for margin expansion from the 787 and 747-8 programmes, as well as the relatively defensive product portfolio in the defence business.
Buy.

52 Week High	\$80.65
52 Week Low	\$56.01
Price to Book Value	19.8x
Dividend Yield	2.3%
Free Cash Flow Yield	6.2%
Dividend Cover	6.7x
Net Debt	\$2.0bn
Interest Cover	9.6x
Emerging markets sales	25%
Next announcement	25 January 2012

Source: Company Data and Bloomberg Consensus



Note: UK investors may be subject to a withholding tax of 30% on dividends from US companies. Dividend yields are stated gross of this withholding tax. We do not automatically reclaim the withholding tax on investments held with us. This will reduce the amount of dividend income that you receive.

Year End	Sales (\$m)	PBT (\$m)	EPS (\$)	PE (x)	DPS (\$)	Yield (%)
Dec 2010	64,306	4,507	4.49	16.6	1.7	2.3
Dec 2011	68,641	5,078	4.48	16.7	1.7	2.3
Dec 2012	78,390	5,598	4.89	15.3	1.8	2.3
Dec 2013	85,643	6,634	5.81	12.8	1.8	2.4

Background

Boeing is one of the world's leading aerospace and defence companies, with total revenues in 2010 of \$64bn. It is divided into two main operating divisions: Boeing Commercial Airplanes (53% of 2011 revenues) and Defense, Space & Security (47% of 2011 revenues). Boeing Capital Corporation supplies financing for other divisions' products, but is relatively immaterial in terms of revenues.

Boeing Commercial Airplanes (BCA)

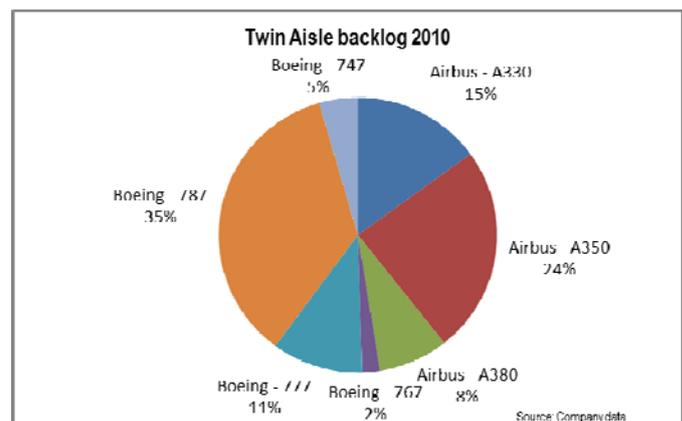
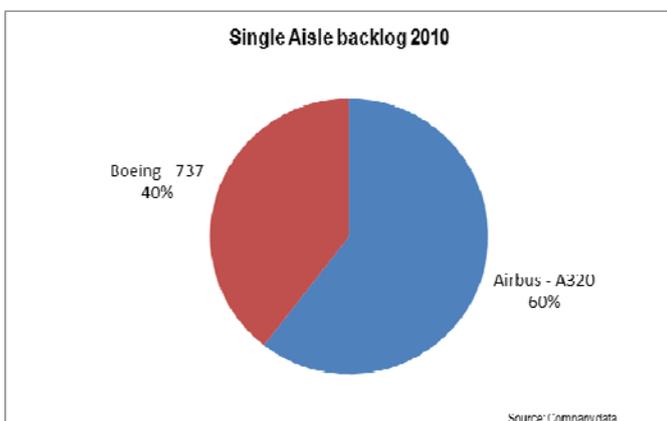
BCA had 2010 revenues of \$32bn, with 462 airplanes delivered and 530 orders received. Approximately 85% of revenues come from airplane programmes, with the remainder from services. Deliveries this year are expected to be around 480 units (down from guidance of 485-500 units at the beginning of the year), with revenues of \$36bn-\$37bn (down from \$36bn-\$38bn) at a margin of 9.0%-9.5% (up from 7.5%-8.5%). The current order backlog is worth \$273bn, up from \$256bn at the end of last year.

Commercial airplane market

Boeing is very positive on the commercial aerospace market, where it operates in three segments: single aisle, twin aisle and services for airlines. All three segments are large and growing, with demand for airplanes forecast to be \$4trn over the next 20 years, with passenger and freight markets forecast to grow at 1.5x GDP. Demand is coming from both the expansion of fleets as well as re-fleeting, with 40% of demand over the next 20 years expected to be to replace older aircraft with more fuel-efficient versions. This means that, even if passenger number growth slows, many airlines will still take the ordered airplanes. Over the next 20 years, Boeing estimates that 32,500 airplanes above 100 seats will be needed, with 23,000 single aisle, 7,300 twin aisle and 1,000 large airplanes. China alone will need an estimated 4,000 airplanes over the next 20 years, costing \$480bn, and will be the second largest market. In single aisle, demand is being driven by low cost carriers and emerging market demand, especially in Asia. In twin aisle, demand is coming from route liberalisation, as well as the capabilities of new airplanes, which allow new routes to be opened up more profitably. The services market is growing strongly as airlines look to reduce costs and infrastructure by greater use of outsourcing of maintenance.

Competitive environment

The competitive environment has essentially been a duopoly, and it remains so in the twin aisle market. In single aisle, there has been the emergence of new competitors, such as Embraer which has been selling the E-Jet single aisle aircraft since 2002, and has recently announced a re-engined version, expected to enter service in 2018. Bombardier has announced the C Series, a 70% composite bodied airplane seating up to 130 passengers. It will compete at the bottom end of the 737 market, and has secured over 150 orders, together with an additional 150 options. Boeing intends aggressively competing against them, despite getting off to a slow start. A state-backed Chinese company, Commercial Aircraft Corporation of China (COMAC), is also working on a single aisle competitor, the C919, a 156-seat competitor to the 737, with a targeted introduction date of 2016. The duopoly will be ending over the next decade, and competition is going to be strong, with the A320neo a strong competitor in the single aisle market, but Boeing believes it is well positioned to take a 50% market share with their new products.



Boeing product line

Over the past five years, Boeing has refreshed its entire product line.

737 – It introduced the 737-900ER in 2007, which improved capacity and range, to compete with the Airbus A321, and it has been very successful, having received an order for 100 aircraft from Delta this year. Boeing has also recently delivered a 2% fuel burn improvement and has now delivered a 7% fuel burn improvement since the introduction of the 737NG in 1997. There has also been a significant improvement to the interior, with the Boeing Sky Interior from the 787 Dreamliner, which has been well received by customers. In order to compete effectively with the A320neo, a re-engined version of the A320 with aerodynamic enhancements, Boeing is introducing a new re-engined version of the 737, the 737 MAX (decided as a lower risk alternative to developing a new airplane), which will use the highly efficient CFM LEAP-X engine, the same as the A320neo and C919 will use. It has enjoyed strong customer interest with more than 500 commitments from customers since its launch in September 2011. The 737-800 currently has a 9% operating cost advantage per seat over the Airbus A320. The 737 MAX will allow Boeing to retain the operating cost advantage, at around 7%, against the A320neo, and allow it to get a premium in terms of pricing. The targeted date for entry into service (EIS) is 2017, but could come sooner depending on production process; after the 787 fiasco, Boeing is looking to under-promise and over-deliver. Southwest Airlines has recently become the launch customer for the 737 MAX, having placed an order for 150 aircraft valued at \$19bn.

Customer preference had been for an entirely new single aisle airplane using similar technology as in the 787 Dreamliner, as this would deliver double-digit operating cost improvement but with an end-decade EIS. Instead it was decided to re-engine the 737, which would reduce risk for customers over time and give efficiency improvements sooner. It would also reduce risk for Boeing, with its significant expertise in 737 production, and allow the capital saved to be used for 777 improvements and the stretched 787 version.

777 – Boeing introduced the 777 freighter in 2008 and has seen strong growth, consolidating its leading market share in the freighter market of close to 90%. The 777 passenger airplane has been highly successful, but will be challenged when the A350-1000 comes to market. Boeing is currently looking at what sort of improvements it will need to make to the 777 in terms of customer requirements, the final capabilities of the A350-1000 as well as a timing issue in terms of the proposed 787-10X. Boeing is committed to invest to ensure the 777 remains the most fuel efficient and capable plane in the 350-400 seat market.

747 – Boeing's latest 747 model, the 747-8 recently entered service in its freighter version, with the passenger version expected in early 2012, having completed testing in October 2012. It is Boeing's largest 747 with a lengthened fuselage, redesigned wings, Dreamliner inspired interior and improved efficiency. It will provide similar trip costs and 13% lower seat mile costs than the 787-400, as well as 26% more cargo volume. The 747-8 is more than 10% lighter per seat than the A380 and will consume 11% less fuel per passenger. The freight version will have equivalent trip costs and 16% lower ton-mile costs than the 747-400, plus 16% more cargo volume. Its empty weight is 80 tonnes lighter than the A380F, resulting in 21% lower trip costs and 23% lower ton-mile costs. The 747-8 programme is 2 years late and the initial airplanes delivered don't meet the performance guarantee with weight and fuel burn issues, but Boeing is working with customers and GE, and is confident of solving the issues. So far four have been delivered, and there is a backlog of 110 airplanes with two-thirds being freighters.

787 – The 787 is an entirely new, highly technologically advanced airplane, making extensive use of composite materials and highly efficient engines. It is mid-sized, carrying 210-250 passengers in the 787-8 configuration and 250-290 in the 787-9 configuration, but offers a range of larger planes of 7,500-8,000 nautical miles. Composite materials make up 50% of the primary structure of the 787 including the fuselage and wing. New engines from General Electric and Rolls-Royce will represent a nearly two-generation jump in technology for the middle of the market and allow the 787 to operate at the highest speed in the market, whilst using 20% less fuel and having a 10% lower operating cost than the 767.

The 787 programme was launched in April 2004 with a record order from All-Nippon Airways and the first flight occurred on December 15, 2009. Over 820 airplanes have now been ordered. The first delivery of a 787-8 (with Rolls Royce engines) took place in September 2011 and with two more delivered by the end of 2011. The 787-8 with GE engines should be flight certified in early 2012. The 787-9 stretched version is in development now, for delivery at the end of 2013 or early 2014. The certification and flight test programme will

be significantly reduced, as much of the work is done for the 787-8. Some customers have converted their orders from 787-8 to 787-9 as they have found its capabilities more attractive.

Boeing is considering a further stretched version, the 787-10X, which would offer around 320 seats, although at a cost of a 1,000 nautical miles shorter range. It would not involve a significant amount of new work, other than stretching the fuselage and using more powerful engines. This would allow it to compete against the Airbus A350, with it having at least a 10% operating cost advantage over the A350-900 and at least a 6% operating cost advantage over the A350-1000.

Production rate increases

Boeing doesn't have the production capacity currently to meet either wide or narrow body demand today, so it is working on increases in the production rates of all five major commercial airplane programmes: the 737, 747-8, 767, 777, and 787. The 737 programme is currently at 31.5 airplanes per month, with the plan to move to 35 per month by mid-2012, 38 by mid-2013 and 42 by mid-2014. The 777 will increase from 7 to 8.3 a month by early 2013, the 747-8 from 1.5 to 2 a month and the 767 from 1.5 to 2 a month with the ability to go higher to meet the US Airforce tanker demand. The 787 production line has recently been increased from is currently at 2 per month to 2.5, with a target of reaching 10 by the end of 2013 as the new production facility in Charleston comes on line mid-2012.

Two of the main risks to achieving the production rate increases are around labour and the supply chain. Boeing has had a chequered labour relations history that has seen three strikes over the last four negotiations (including a two-month stoppage in 2008 that cost \$6.4bn in sales). However, in December it announced an agreement with its main union that removed the main issues that existed between the two parties and removes the perceived strike risk for Boeing. Production is highly dependent on the supply chain, and hence a lot of time is spent on managing it and understanding the demands on the supplier, not just from Boeing but also from its competitors. A distributed global supply chain gives access to capital and technology but does increase the risk and need for careful management.

Constant productivity improvements

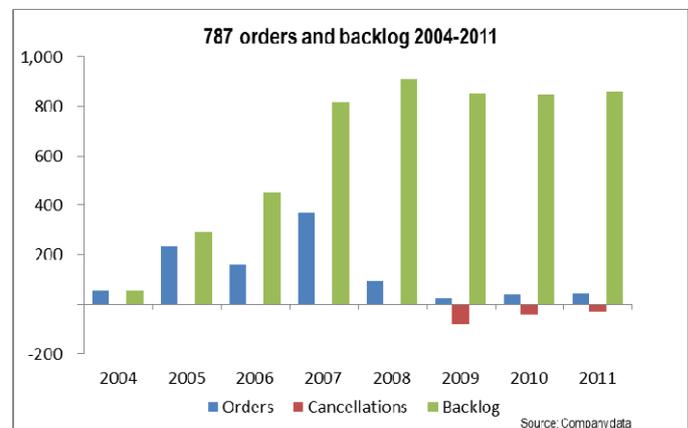
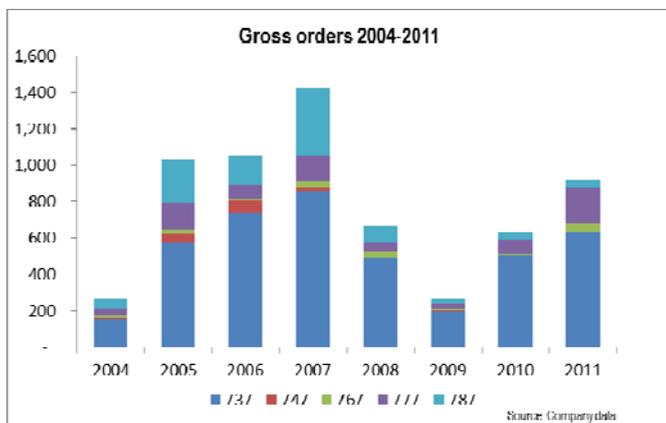
There is a significant focus on continuous quality and productivity improvements through a lean production system, specifically focusing on the 737, 777 and 767 models. A mature Lean+ line allows Boeing to make the planned production rate increases whilst enhancing quality and cost efficiency, and mitigating waste. On the 737, Boeing has achieved a 50% factory time reduction, a 41% cost of quality reduction and a 41% floor space reduction. On the 777, Boeing has achieved a 27% factory time reduction, a 35% cost of quality reduction and a 17% floor space reduction. On the 767, Boeing has achieved a 13% factory time reduction and a 44% floor space reduction.

787 programme

Due to the development cost and number of airplanes in the backlog, the 787 programme is crucial to Boeing's future. It should be as profitable as the 737 and 777 programmes, however currently it has very low initial profitability as with the programmes had, the key is driving profitability over the programme. The initial planned quantity for the 787 is 1,100, which is used in programme accounting for the airplane, which amortises unit production costs and tooling over the accounting quantity. This should be about 10 years of production under current planned production rates. Boeing currently has confirmed orders for 860, with options on an additional 200 and is targeting total orders of 1,500 by end-2012. Boeing believes that the addressable market for the class of plane is 5,000, so an accounting quantity of 1,100 is not being overly aggressive. In addition, it has long-term supplier agreements in place, which provide a strong basis for costing estimates. The initial booking gross margin for the 787 is in the low single digits, which takes into account the cumulative impact of delays and production challenges. Programme accounting results in the creation of a deferred production cost asset as the initial development, tooling and production setup costs are spread across the targeted production units and amortised over time. There are currently \$9.7bn of 787 deferred production costs which includes over 40 units still in progress. The production setup costs will only tail-off after around 45 units, when it will get to more normal learning curve levels. The deferred production costs will increase over time as new variants are introduced and should only begin to decline around a year after production reaches 10 units a month, at which time unit margin should exceed programme margins.

Current order book

Boeing's current backlog is around 3,500 aircraft, worth \$273bn, with over \$20bn added in the last quarter. The book to bill ratio was over one this year and is expected to remain over one for 2012 and 2013. This backlog under pins the production increases announced across the product family, and accounts for between three and seven years of production, depending on the aircraft type. The backlog is diverse by geographic region and product type, with two-thirds outside the US and Europe, and European exposure only around 15%. The key is for Boeing to stay close to its customers in order to understand passenger numbers, load factors and yields. With a lot of the demand being driven by re-fleeting, Boeing believes that a short-term macro slowdown should not impact the backlog, as it has focused on ensuring a better quality of backlog, with high credit quality customers that take their ordered airplanes. Freight traffic has tailed off since July, which is usually a leading indicator, but passenger traffic is still growing strongly at 6%, and airlines have been much better at managing capacity. This is reflected in the backlog, which is 95% passenger. Boeing are monitoring the European debt situation in terms of its impact on the airplane financing market, but believe that market is diverse enough and with rates remaining at record low levels, for there to be little impact on demand.



Boeing Defense, Space & Security

Boeing Defense, Space & Security is one of the largest defence contractors in the world, similar in size to Lockheed Martin and BAE Systems. In 2010, the division had revenues of \$31.9bn, won orders of \$32.0bn and had margins of 9.0%. 2011 guidance is for revenues of \$31.5bn-\$33.0bn with a margin of 8.5%-9.0%. It has a current order backlog of \$66bn. Its main addressable markets are Military Aircraft, estimated at a \$400bn market size over 2010-2019, Networks & Space, estimated at a market size of \$300bn and covering areas such as satellites and communications, Services & Support, estimated at a market size of \$300bn and covering areas such as logistics, supply chain and training, and Adjacencies, estimated at a market size of \$700bn and covering areas such as information services, infrastructure, cyber-warfare and security.

Current defence spending environment

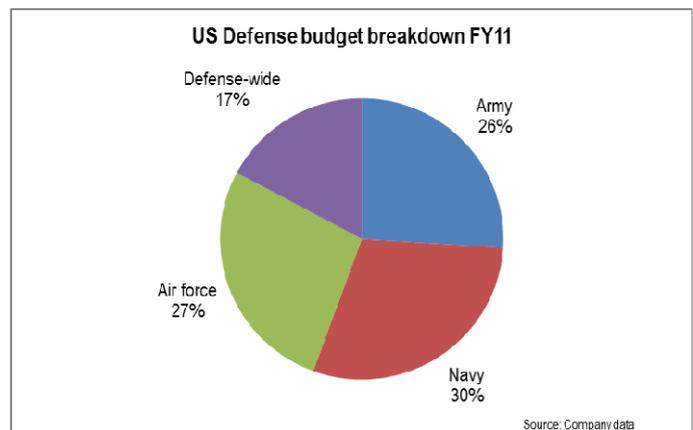
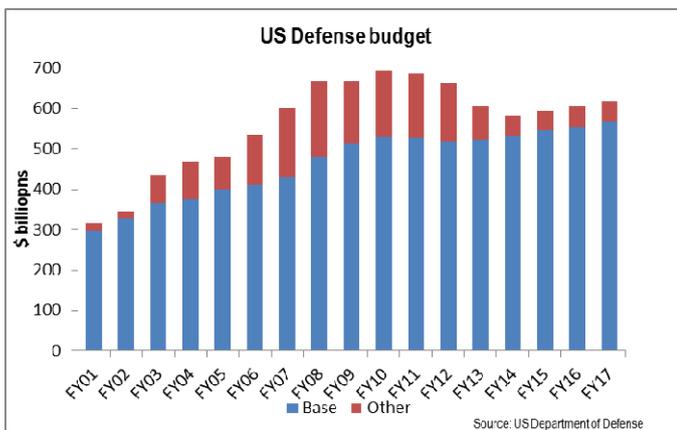
The current environment is that the global financial crisis has constrained defence budgets in the west, forcing austerity although at a time of continued threats. This is balanced by the Middle East and Asia, where there are no budget pressures and both increased need and ageing equipment. The US Defence budget is of key importance as, at around \$700bn, it represents 45% of global defence spending. Overall US budget constraints are significantly reducing defence spending over the next 10 years.

Initial budget cuts announced for 2012-2016 were for actual cuts to projected spending of \$78bn, as well as \$100bn of efficiency savings that would be re-invested in priority programmes. This would have resulted in a 2012 base spending of \$553bn, with the majority of cuts coming from non-operational areas, such as reduced civilian hiring, salary freezes of administration staff, cutting DoD overheads, reducing healthcare costs, cutting smaller contractors and changing economic assumptions, such as salary inflation.

Recently, further cuts have been announced that will result in a total cumulative reduction in defence spending of \$487bn over the period to FY2021. This will set a FY2013 base budget of \$523bn and will increase with inflation for the next five years. The net result is

a real reduction of 4% in total base budget for the 2013-2017 period when compared to 2008-2012. These cuts will result in greater impact on weapons programmes, however the Air Force, where Boeing supplies the majority of its products, appears to be less impacted than the other services.

There is a risk that if Congress doesn't agree on overall budget cuts, additional automatic spending cuts will be triggered under The Budget Control Act, which Congress passed in August 2011. These sequestration cuts, as they are known, will be in addition to the \$487bn and would result in the FY2013 base budget falling to roughly \$472bn. Sequestration cuts will result in the shutting of some production lines which could be terminal for those programmes, and damage the industrial base, hence there is significant political will to avoid this.



Impact on Boeing

The competitive response by the defence industry has been in differentiated pricing, cutting costs and reshaping product portfolios. Boeing believes that its portfolio of proven, reliable and affordable products and services provides more relevant and economically attractive choices for the customer. Its strategy is to extend and grow existing programmes, capture greater share of services, expand internationally and invest in growth areas such as unmanned systems, cyber security and intelligence. In addition, on the operational side, it is looking at ways to improve productivity, and reduce overhead and infrastructure costs, in order to generate meaningful cost savings for customers and fund investment in growth.

While the ultimate outcome of the US Defence budget is difficult to forecast, Boeing has been successful in mitigating the impact and continuing to drive revenues. Budget constraints have limited procurement of some fifth generation fighters, resulting in extended operating lives for existing types, allowing Boeing to benefit from service and upgrade revenues. Boeing has also been successful in extending existing programmes, with the recent announcement of its retaining its position as the contractor on the US long-range missile shield. This is a \$3.5bn, seven-year contract to develop, test, engineer and manufacture missile defence systems. Looking at the proposed FY2012 broken down by weapons system spending, the impact on Boeing can be estimated by the proposed spending on weapons systems where it is the sole or a joint contractor. The proposed spending on these programmes in FY12 is \$28.5bn, down only 1% from FY11 and down only 2% from FY10.

On the international side, its portfolio of proven military aircraft, at attractive prices but updated with the latest electronics and aerodynamic enhancements, has proven attractive to several countries. It has been particularly successful in Saudi Arabia, with a contract to supply 84 new F-15s, upgrade another 70 F-15s, supply up to 70 Apache AH-64D helicopters and 36 AH-6i helicopters, as well as offer all the required support and training. The first new F-15s are expected to be delivered in early 2015, with deliveries taking about five years to complete, extending the F-15 production line toward the end of this decade. The first modified Saudi F-15s are expected to enter overhaul in mid-to-late 2014. The total value of all contracts would provide Boeing with \$24bn in sales.

On the operational side, Boeing is working to reduce costs, with several facilities being closed. The new US Airforce in-flight refuelling tanker (KC-X), which is based on the 767, will be built almost entirely on the 767 production line, rather than requiring a separate production line as in the past. The total contract is for 179 aircraft and is worth around \$35bn.

Whilst the US Defense budget is an important driver for Boeing Defense, Space & Security, it does have a very strong portfolio of well understood products in terms of capability and cost, while still well being represented in growth areas of spending, and hence has less reliance on cutting edge, high development cost programmes at risk from the defence cuts.

Balance sheet strength

Boeing has total cash and equivalents of \$9.2bn. It has total debt of \$9.0bn, of which \$3.4bn relates to Boeing Capital Corporation. It has an A credit rating from all the major rating agencies. It recently raised \$750m of new debt to take advantage of low rates and to prefund maturities for next year.

Valuation

Boeing is an attractive investment opportunity due to a number of factors. It has strong exposure to the secular growth theme of increasing passenger air travel, especially in emerging markets. It enjoys an effective duopoly in the segments of the commercial aviation market in which it operates, with little effective competition likely for the next decade. With strong demand for airplanes, both for growth in capacity as well as re-fleeting by operators in order to improve efficiency and emissions, it has strong revenue visibility with a backlog equivalent to around five to six years of production. It has put in place a credible plan to increase production to meet the backlog, whilst improving profitability. It also has a product roadmap to ensure it retains its leading competitive position on efficiency. In the defence business, Boeing has a stable, well diversified product portfolio with a mix of mature, well understood products along with development programmes in high-growth areas such as unmanned and cyber-warfare. While the US Defense budget cuts are a major issue for the defence industry, the market appears to be pricing in significantly negative defence spending, beyond even the most draconian proposals being put forward. Whilst cuts are going to be made, the threats that face the US and its allies have not diminished, so US defence spending will become more targeted whilst spending by allies, especially in the Middle East and Asia, will increase in response.

Boeing is currently trading at 15.3x consensus 2012 earnings and 12.8x consensus 2013 earnings, a premium to its commercial aviation comparatives and its defence comparatives. We believe that the premium is justified given the stage that Boeing is at in terms of the ramp-up of production in commercial airplanes and the initial low margins from the 787 and 747-8 programmes, as well as the relatively defensive product portfolio in the defence business. Buy

Comparative valuation				
	Mkt cap (\$m)	PE 2011 (x)	PE 2012 (x)	PE 2013 (x)
BOEING CO/THE	55,222	16.7	15.3	12.8
Aviation comparatives				
UNITED TECHNOLOGIES CORP	68,691	13.8	13.2	11.3
EADS NV	26,062	26.4	14.3	10.9
ROLLS-ROYCE HOLDINGS PLC	22,031	16.9	14.2	12.7
DASSAULT AVIATION SA	7,710	17.0	14.9	13.2
BOMBARDIER INC-B	7,200	9.0	8.1	6.7
TEXTRON INC	5,950	18.3	12.8	9.6
EMBRAER SA	4,898	12.1	11.3	10.4
		14.1	11.8	10.0
Defence comparatives				
LOCKHEED MARTIN CORP	26,128	10.6	10.4	9.6
GENERAL DYNAMICS CORP	24,828	9.6	9.1	8.8
RAYTHEON COMPANY	16,872	9.7	9.2	8.4
NORTHROP GRUMMAN CORP	15,259	8.3	8.6	8.5
BAE SYSTEMS PLC	15,275	7.7	7.4	7.4
		9.2	8.9	8.5

Risks with this recommendation

- Expected growth in air travel may slow if the global economy slows.
- The significant production rate increases planned may not be reached.
- Production problems on the 787 may take longer to iron out than expected.
- Chinese market share may fall if C919 is successful.
- US defence spending may come under more pressure if budget sequestration is triggered in the US.

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Equity Research			Fund Research		
Large Cap	Mid Cap	Global	Absolute Return	Income	Growth
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