KILLIK & Co

19 January 2012

Mid Cap

.COMPANY:	EPIC:	MARKET CAP:	RECOMMENDATION:	RISK RATING:	PRICE:
Senior	SNR.L	£734m	Buy Initiating Coverage	7 CATEGORY: UNRESTRICTED (see bottom of note for risk categories)	183P

Senior is an international manufacturing group that designs, produces and markets high technology components and systems to the civil aerospace, defence, diesel engine, exhaust system and energy markets.

Investment case

- Exposure to increasing aircraft build rates, with content on key Boeing and Airbus programmes.
- The management team has a strong track record of successfully integrating new businesses, with the recent Weston acquisition providing further exposure to Airbus.
- The Flexonics business provides exposure to emissions legislation and emerging clean energy technologies.
- A recovery in heavy duty truck markets in developed economies would provide further support to Flexonics.
- An excellent track record has resulted in market share gains, aided by lean manufacturing techniques.
- The importance of the group's content to aerospace platforms provides high barriers to entry.
- Senior is highly cash generative, with operating cash conversion of 116% in 2010, and has a robust balance sheet.

Although fairly rated against domestic peers, at 10.5x 2013 consensus earnings, when valued against overseas peers, particularly in the US, the group is trading at a discount to the sector. The prospect of further earnings growth, driven by market share gains or complementary acquisitions and an end market recovery in Flexonics provides the scope for further earnings upgrades, while the prospect of a takeover bid from a larger industry player provides further support to the valuation. We initiate coverage with a Buy recommendation.

52 Week High	194p
52 Week Low	129p
Price to Book Value	3.3x
Dividend Yield	2.0%
Free Cash Flow Yield	5.7%
Dividend Cover	3.8x
Net Debt	£62.9m
Interest Cover	5.8x
Emerging markets sales	c.10%
Next announcement	27 February 2012

Source: Company Data and Bloomberg Consensus

Year End	Sales (£m)	PBT (£m)	EPS (p)	PE (x)	DPS (p)	Yield (%)
Dec 2010	567	52	10.11	18.1	3.1	1.7
Dec 2011	629	76	13.80	13.2	3.6	2.0
Dec 2012	714	86	15.80	11.6	4.0	2.2
Dec 2013	760	94	17.40	10.5	4.4	2.4

Jonathan Jackson (Head of Equities)
Arjun Venu (Equity Analyst)
Nicolas Ziegelasch (Global Equity Analyst)
Mick Gilligan (Head of Research)

Senior is an international manufacturing group that designs, produces and markets high technology components and systems for the principal original equipment manufacturers (OEMs) in the worldwide civil aerospace, defence, diesel engine, exhaust system and energy markets. The group consists of two divisions: Aerospace and Flexonics.

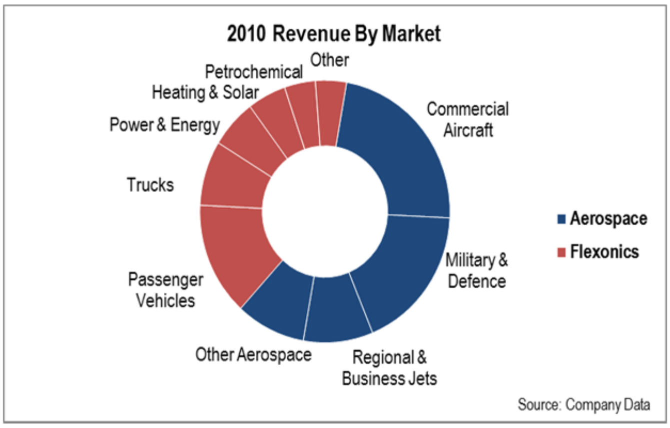
Aerospace

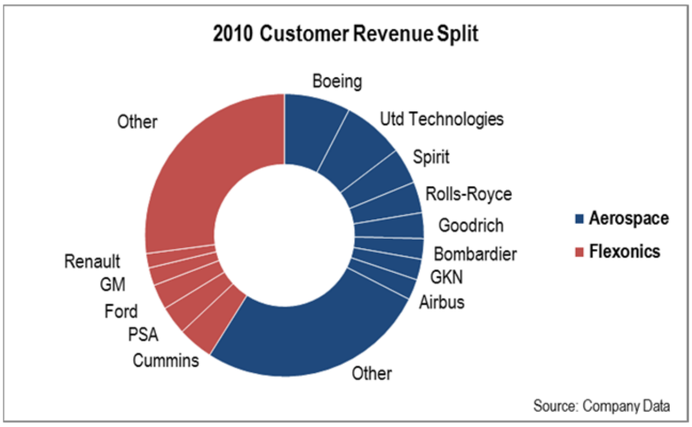
Senior Aerospace is a market-leading provider of components and systems for OEMs, and in 2010 accounted for 59% of group revenue, with over 80% of divisional revenue generated from the aerospace sector. Its products include engine structures and mounting systems, ducting systems, structural parts such as airframes, machined parts for helicopters, and fluid control systems. The group provides content for a number of large aircraft, including Boeing's 737, 777 and 787 Dreamliner, the Airbus A320, A330, A350 and A380 series, Gulfstream's G500 and G550, the Lockheed Martin C-130 military air-transport aircraft and Sikorsky's Black Hawk helicopters. Senior Aerospace's services are divided into three segments:

Structures supplies precision machined products and assemblies for airframe structures and systems. The group adds value by replacing complex assemblies with single-piece components, and by kitting and assembling these parts for OEMs. Structures has significant exposure to large commercial and military aircraft, and stands to benefit from increased outsourcing by major customers, such as Rolls-Royce and Boeing, and from increased aircraft build rates. The segment has high exposure to Boeing, and to Sikorsky's Black Hawk helicopters, and the group is seeking to reduce this bias, through increased outsourcing from existing clients, with growth in Europe, Asia, Airbus and non-Black Hawk military aircraft.

Gas turbine engines manufactures engine core, ancillary systems and related structural products for engine manufacturers to enable operation in demanding aero-engine operating conditions. Engine build rates are expected to drive demand, particularly as engine manufacturers aim to increase fuel efficiency to meet emissions standards and reduce costs. Additionally, Senior expects to benefit from the development of new technologies, and from developing existing relationships with clients, such as Rolls-Royce, as they seek to outsource manufacturing exercises. Senior also hopes to capture growth through focusing on more flight-critical components.

Fluid conveyance systems provides ducting and manifolds to deliver air, hydraulic fluids and fuel to airborne systems, providing end-to-end, maintenance-free delivery solutions in a range of composite and metallic materials. The group's success in content design has seen it win contracts to provide content on new programmes, such as Lockheed Martin's Joint Strike Fighter and Bombardier's C Series. The segment has higher margins than Aerospace's other two segments, and Senior is seeking further growth through securing design content on new programmes, and by moving into adjacent categories – including non-aerospace applications, such as medicine and semiconductors.





Flexonics

Flexonics is the largest manufacturer of flexible automotive components in the world, with a major focus on diesel engines, and in 2010 accounted for 41% of group revenue. The division's diesel technology products include flexible mechanisms for vehicle exhaust systems, cooling and emission control components, and pipework for diesel fuel distribution. The division also produces industrial components, principally expansion joints, control bellows and hoses, to clients in the power and boiler markets, oil and gas and chemical processing industries, heating, ventilation, and air conditioning (HVAC) and solar markets and other industrial markets. Flexonics' services are divided into two segments:

Land vehicle emission control focuses on the development of diesel technologies to support a growing number of major passenger vehicle and heavy truck manufacturers, such as Cummins, in meeting stringent emissions standards. The group stands to benefit from a recovery in mature heavy duty truck markets, such as North America and Europe, as well as the positive conditions in the global passenger vehicle market, particularly in emerging economies. The group will continue to develop its portfolio in order to meet increasing emissions legislation standards, focusing on growth in heat exchanger applications as well as heavy duty diesel engine emission control programmes. Also, with developing markets offering low-cost production, the group is increasingly seeking to move manufacturing beyond Europe and North America.

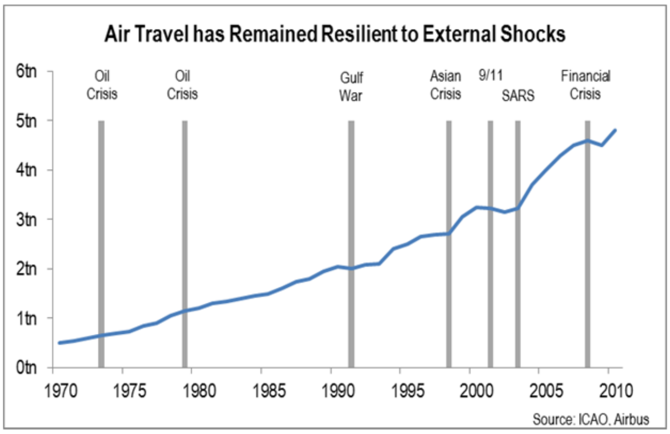
Industrial process control designs and manufactures fluid conveyance products for a range of industrial process applications, mainly in the petrochemical and power generation industries. The segment is well positioned to capture increased spending on maintenance and equipment upgrades, driven by emissions legislation. The group is also investing into new alternative energy solutions, such as solar power and fuel cell technology. Senior's products are largely one-off in nature, and the group believes that, in addition to emissions legislation, growth will be driven by expanding into adjacent products and increasing its presence in Europe and Asia.

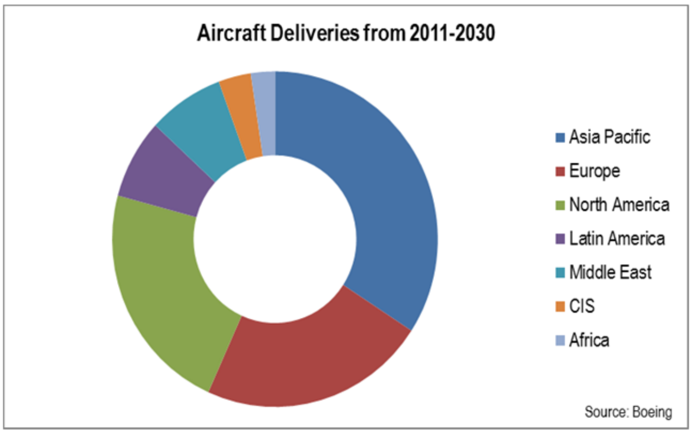
Although more cyclical than the aerospace division, Flexonics provides exposure to a recovery in the heavy duty truck market, in addition to a wider recovery in the industrial sector, given the group's exposure to construction equipment and process plants. During the financial crisis, the division saw revenue decline by 11%, as demand for land vehicles resulted in a dramatic fall in volume in the first half of 2009, resulting in a 32% decline in half-year profit. The group took action to flex its cost base, and for the full year managed to improve operating margins by 140 basis points, to 11.8%, which was also partly due to mix improvements and the positive operating leverage effect of a recovery in land vehicle volumes in the final quarter.

Key Growth Drivers

1. Aircraft build rates

Senior provides content on most key aerospace growth platforms, particularly new platforms such as the Boeing 787 Dreamliner and the Airbus A380. Boeing currently estimates that between 2011 and 2030, passenger aircraft deliveries will total 33,500 aircraft, representing an opportunity worth up to $4.0 trillion. This will coincide with global air traffic (as measured by revenue passenger kilometres) increasing from just under 5 trillion, to around 13.5 trillion, led by middle class expansion in emerging markets, increased domestic travel in the US and rising travel within Western Europe.





The extensive order books at OEMs such as Boeing and Airbus, often announced publicly, give the group significant revenue visibility. Boeing and Airbus entered 2011 with order backlogs of around seven years, worth over $500bn, with over 50% coming from emerging markets, and Airbus expects deliveries to increase by 40% over the next five years. As at 30 November, Boeing and Airbus reported order backlogs of 3,534 and 4,456 aircraft, respectively. Although the IATA recently cut its forecast for industry profit, it is also worth noting that between 2003 and 2007, although the airline industry was unprofitable, OEM share prices rallied strongly.

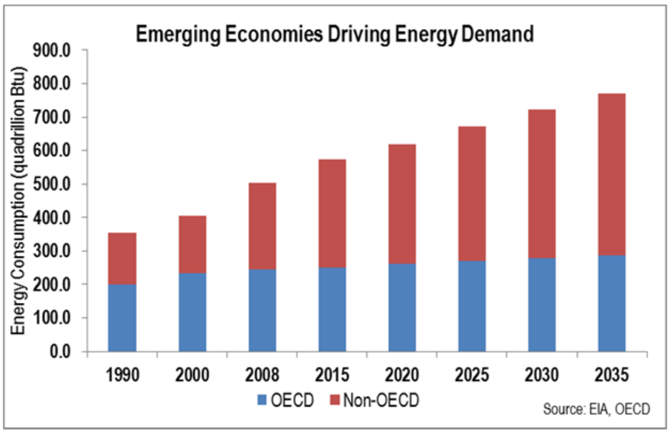
Near-term deliveries and monthly production on key platforms have been increasing steadily, and average monthly deliveries are expected to grow significantly, driven by structural growth in Asian airlines, which represent the biggest contributor to the current backlog and where air travel markets remain under-equipped. India remains the biggest contributor to air traffic in the region, and recent data suggests that domestic air traffic grew by 20% in the third quarter of 2011, with further growth in the final quarter driven by the holiday and festival season. In China, air traffic has moderated, against tougher year-on-year comparatives and with year-to-date traffic levels having been impacted by the Japanese earthquake, however, capacity utilisation remains strong, and Boeing estimates that Chinese new aircraft orders will have reached 4,330 by 2029. This emerging market backlog provides insulation towards a global economic downturn, given the stronger GDP growth rates in the region.

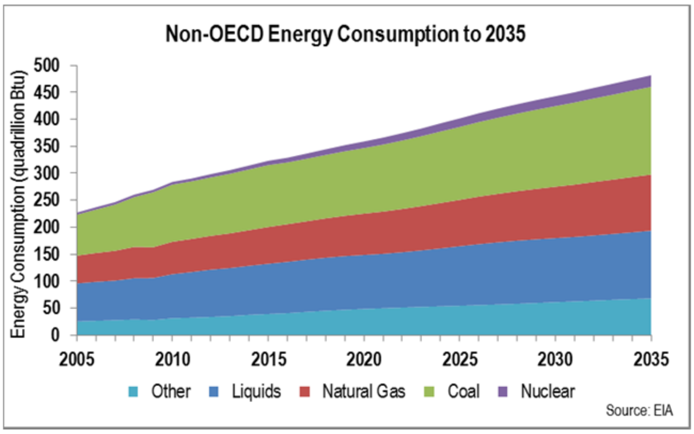
Additionally, much of today's existing fleet will be need to be replaced by aircraft offering greater fuel efficiency and lower emissions as environmental regulations become more stringent and customers seek to reduce costs. The high price of oil, which we expect to persist as a result of rising emerging market demand and constraints over supply, means that fuel costs for airlines are expected to remain significant. One of the legacies of the Arab Spring is that Saudi Arabia needs an oil price of at least $95/barrel to break even on its budget, while continued geopolitical risk surrounding Iran in the run-up to this year's elections is likely to provide further support. We expect this to be a supportive for new aircraft orders, although too high an oil price may squeeze demand for air travel, as operators will seek to pass unhedged fuel price hikes on to customers in the form of higher fares and ancillary revenues such as baggage fees.

In the third quarter of 2011, US carriers such as American Airlines and Delta placed orders for 330 aircraft, representing 47% of all orders received by Airbus and Boeing, as they sought to replace ageing fleets. Despite the weakening global outlook over the second half of 2011, the number of parked aircraft fell further. It is expected that, should the number of aircraft required by the airline industry reduce, carriers will seek to meet reductions initially through accelerating the retirement of older aircraft, then through parking aircraft and lowering utilisation rates, before finally cutting new deliveries. Within the current parked fleet, it is estimated that almost 60% are more than 20 years old, and around one-third of the parked fleet has been parked for over three years. These aircraft are unlikely to return to service, which over the longer term is expected to be positive for OEM order books.

2. Environmental legislation

The group is expected to benefit from demand for emission-related products as global energy usage increases. The US Energy Information Administration (EIA) estimates that energy consumption will increase significantly to 2035, driven by 50% growth in emerging markets demand.





Demand for the majority of the group's products is linked, either directly or indirectly, to increasingly rigorous requirements to reduce carbon emissions through environmental legislation. With coal-based energy consumption expected to remain a significant contributor to growth in emerging markets consumption, and with passenger vehicle sales expected to continue rising, emissions legislation is expected to remain an important driver of fuel efficiency. For OEMs, meeting fuel efficiency requirements can also deliver cost savings, and this should remain supportive of demand for Senior's existing products as well as products in its development portfolio.

This is expected to be one of the main drivers of demand for heavy duty trucks, in both mature and emerging markets, providing underlying growth within a cyclical sector. In emerging markets, demand is expected to be driven predominantly by ongoing industrialisation, supplemented by legislation, such as the Euro 5 emissions standard in Brazil. In developed markets, a recovery in demand is expected to be led by North America, where average fleet ages are at a record high and market fundamentals and trucker confidence remain sound. ACT Research, the leading commercial vehicle data provider, currently expects growth in heavy duty truck shipments of around 20% in 2012.

In addition to improving existing products such as heat exchangers, the development portfolio is focusing on new energy industries. This includes fuel cell technology, such as combined heat and power (CHP) – the production of heat and electricity in a single, efficient process. CHP plants are fuel neutral, with efficiencies of over 80%, compared to around 50% at traditional combined cycle gas turbine (CCGT) plants. The group also supports solar projects involving concentrated solar power, working with companies such as Siemens. At last year's Capital Markets Day, management emphasised that, although renewable energy is a fast-growing market, the group will maintain a disciplined approach as it remains unclear which new technologies will hold in the longer term.

3. Content on new programmes

The group's excellent track record in delivering high quality products to its customers has enabled it to establish strong, long-standing relationships, and secure contracts to provide content on new aircraft and land vehicle programmes with key clients. Senior has a defined and agreed supply into each of its platforms, the value of which it describes as shipset, and the quantum of shipset can vary significantly, depending on the platform. One recent win was the significant content secured on the new Boeing 787 Dreamliner, its largest shipset content ever. The 787 is expected to be a significant driver of growth, given current estimates are for monthly deliveries to increase steadily towards a target of 10 by the end of 2013. Other new programmes include the Airbus A320, where an engine change is in 2016, presenting an opportunity for Senior to build on its existing shipset on the platform. In Flexonics, the successful development of heat exchanger technology used in Senior's exhaust gas recycling coolers will be supplied to the new generation of Cummins heavy-duty diesel engines.

4. Market share gains

In addition to producing market-leading solutions, the group focuses on operational excellence. Following 9/11, the group experienced schedule changes from aerospace customers, volume reductions and increased pricing pressure, which required significant capacity adjustments. As a result, management sought to introduce lean manufacturing principles, in order to drive relative performance in comparison to the peer group.

Lean manufacturing, often interchanged with 'Just In Time manufacturing', is a term that was coined to describe Toyota's business during the late 1980s, which seeks to maximise customer value by applying fewer resources more effectively and efficiently through the elimination of non-valued added activities or waste. This results in reduced throughput times, enabling companies to respond to fluctuations in customer demand.

The provision of lean manufacturing has been an essential component of driving market share gains, as exhibited by the increase in shipset on a number of major platforms in recent years. This has had the effect of not only increasing margins, but also entrenching Senior's position at major OEMs, as the group has built a very strong reputation.

5. Acquisitions

The group's management team has a strong track record of acquiring and successfully integrating new businesses, since making its first acquisition in early 2006 of Sterling Machine, a manufacturer of precision alloy parts used in Sikorsky helicopters, and complementary deals are expected to remain a key feature to the group's growth. Management has spent £211m on acquisitions since

2006, maintaining discipline during the economic downturn to build balance sheet capacity through free cash flow generation in order to pursue complementary acquisitions in both the Aerospace and Flexonics divisions.

Aerospace has been the main focus of acquisitions over the last five years, with just one of the seven companies purchased - Wahlco Metroflex – in the Flexonics division. In Aerospace, following the acquisition of Sterling Machine in 2006, the group acquired Aerospace Manufacturing Tech, a maker of aluminium structural parts used in Boeing aircraft later in the year. In December 2007, the group added Absolute Manufacturing, a maker of complex machining solutions such as proximity sensors and fuel flow metering, and shortly thereafter bought Capo Industries, a maker of super alloy products for turbine engines and auxiliary power units.

Occasionally, OEM customers – seeking to improve their own supply chains – have introduced Senior to potential acquisition targets. Earlier this year, the group purchased Damar, a manufacturer of precision machined parts and assemblies, following an introduction from Boeing. This highlights how strongly regarded the group is by its key customers, but to their credit management have retained strong discipline in making acquisitions, using a tight framework that has been developed over the years to assess acquisitions.

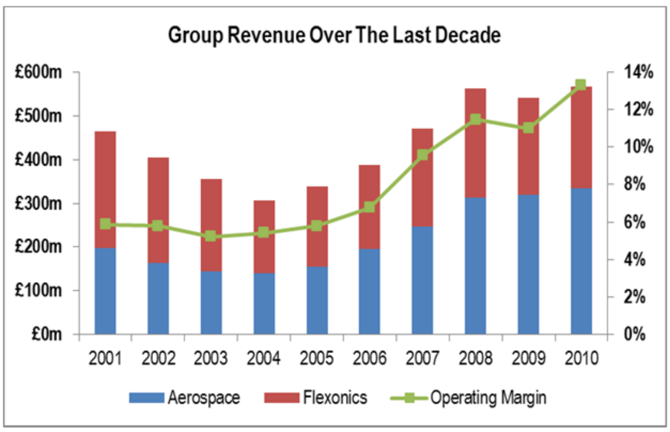
On 28 November, the group announced the acquisition of Weston EU, a manufacturer of precision machine parts used in commercial aerospace, for £54m. Weston derived more than 70% of its year-to-date revenue of £60m directly or indirectly from Airbus – going some way towards realigning the group's heavy weighting towards Boeing in large commercial aircraft, and also expanding the group's content on Airbus platforms into aerostructures. This should also allow the group to improve margins, driven by higher utilisation rates of Weston's low-cost manufacturing capacity in Asia.

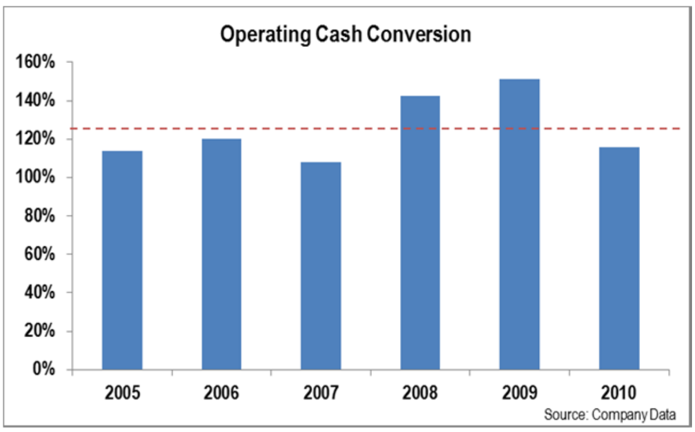
Management's focus on M&A is expected to remain on companies based in North America and the UK, although companies in Asia could also form part of the group's longer-term strategy, should they fit in with the group's targeted criteria of having patented in-house design, high value assembly and a degree of precision engineering.

Financial Considerations

Senior's main strengths are its strong reputation amongst its customers and the excellent revenue visibility in its aerospace business, in which it has established a strong market position. As the group supplies mission critical applications, its importance to aerospace platforms is such that it would be difficult for new industry participants in gaining market share at its expense. Over the years, not only has Senior's strong reputation meant that it has remained on all of its key aircraft platforms, but its shipset value has grown. For example, the group's shipset on the Boeing 787 has grown 27% annually since 2007, whilst on the Airbus A380 it has grown by 31%.

Although Senior's customers have significant buying power, the group has remained profitable in recent years, owing to management's focus on operational excellence. Consequently, the group has been able to generate margins higher than its main customers, although this is a point which management are wary of communicating.





Source: Company Data

The group is highly cash generative, with an average operating cash conversion of 125% since 2005, and its ability to fund its own growth, in addition to paying down debt and maintaining its dividend, illustrates the strength of its operations and management team.

Senior also has a robust balance sheet. Following the acquisition of Weston, net debt is expected to have increased slightly. However, the group's ratio of net debt to EBITDA is only expected to have increased from 0.6x as at 30 June, to 0.8x. This remains well within its principal debt covenant, which is required to be less than 3.0x, which should enable the continued levels of investment into the business and possible bolt-on acquisitions.

Although 2011 was expected to be a transitional year for Senior – with revenue from key aerospace platforms not expected to flow through until 2012 and rising input costs for land vehicles expected to dampen growth – recent trading has been strong. On 25 October, the group issued a trading update, in which it confirmed that Aerospace continued to see strong order intake levels over the third quarter, driven by the decisions by Airbus and Boeing to invest in more fuel-efficient engines and strong build rates for defence customers. The performance of the Flexonics division was in line with expectations as increased production of heavy trucks – particularly in North America – offset a softening in European passenger vehicles. This followed the interim results on 29 June, which beat expectations, as the group benefited from a recovery in global truck markets and increased production of the C-130J military aircraft and the Boeing 787, which offset weakness in the European passenger car market, leading management to upgrade its expectations for the full-year.

Senior pays a dividend which is well covered by earnings. Although the dividend was held flat in 2009, in 2010 it was increased by 20%, to 3.12p – covered 3.8x by underlying EPS. This year's interim dividend came in ahead of expectations, up 15%, to 1p.

Valuation

The group had seen ongoing upward revisions to consensus EPS forecasts over the last twelve months, with estimates upgraded by 14% for 2011 and up 20% for 2012. This has resulted in Senior's shares trading at a slight premium to its UK-listed peers, at 10.5x consensus 2013 earnings. However, when valued against its overseas peers, particularly in the US, the group is trading at a discount to other high quality engineering firms which provide equipment to OEMs. This could be a reflection of the recent dollar strength against sterling, although given that the cost base of Senior is largely dollar-denominated, this provides a natural hedge to currency movements in either direction. Consensus expectations are that the 2011 full-year dividend will amount to 3.6p, equating to a yield of 2.0%, based on a similar payout ratio to 2010.

Given the group's strong cash flow generation, solid balance sheet and track record of successfully identifying and integrating acquisitions, we believe that Senior will continue to generate positive earnings growth. Additionally, the potential for further consensus upgrades is provided by the prospect of increased shipset values on key platforms, complementary acquisitions and end market recovery in key Flexonics markets. Furthermore, given the ongoing M&A activity in the midcap engineering sector, the group could find itself vulnerable to a bid from a larger player.

	PE			Dividend Yield			EV/EBITDA		
	2011	2012	2013	2011	2012	2013	2011	2012	2013
Senior	13.2x	11.5x	10.5x	2.0%	2.2%	2.4%	7.6x	6.8x	6.3x
UK Peers									
Meggitt	11.8x	10.6x	9.8x	2.8%	3.0%	3.2%	8.7x	7.7x	7.2x
Cobham	9.4x	9.3x	8.8x	3.5%	3.8%	4.2%	5.9x	6.0x	6.0x
UMECO	13.5x	11.6x	10.4x	3.4%	3.7%	4.2%	6.4x	5.9x	5.3x
Overseas Peers									
MTU Aero Engines	13.7x	12.0x	10.5x	2.3%	2.6%	2.9%	6.4x	5.8x	5.2x
Zodiac Aerospace	13.8x	12.3x	11.7x	2.1%	2.3%	2.6%	9.1x	8.4x	8.1x
Dassault	16.8x	14.7x	13.0x	1.7%	1.9%	2.2%	9.6x	8.7x	8.9x
Safran	14.2x	11.6x	9.7x	2.6%	3.2%	3.9%	6.8x	5.9x	5.2x
BE Aerospace	18.6x	15.2x	15.2x	0.0%	0.0%	0.0%	10.6x	9.0x	9.0x
Rockwell Collins	12.8x	11.4x	10.3x	1.8%	1.9%	2.0%	7.6x	7.0x	6.4x

Transdigm	17.5x	15.5x	13.2x	0.0%	0.0%	0.0%	10.9x	9.9x	9.0x
Triumph Group	13.4x	11.7x	10.1x	0.2%	0.2%	0.3%	7.7x	7.0x	6.0x
Esterline Tech	11.3x	9.8x	21.4x	0.0%	0.0%	0.3%	7.6x	6.8x	9.5x

Risks with this recommendation

- A major downturn in the aviation sector, driven by macroeconomic conditions or an unforeseen incident such as a terrorist attack or plane crash.
- The Flexonics business is highly cyclical, and a downturn in industrial production and consumer spending on cars would also impact Senior negatively.
- The emergence of emerging market competitors could present a risk in the longer term.

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KILLIK & Co RESEARCH RECOMMENDATIONS					
Equity Research			*Fund Research*		
Large Cap	*Mid Cap*	*Global*	*Absolute Return*	*Income*	*Growth*
Investment ideas in the FTSE 100 which we believe will generate returns ahead of the All-Share index.	*Investment ideas in the FTSE 250 which we believe will generate returns ahead of the All-Share index.*	*Global investment ideas which we believe will generate returns ahead of the FTSE World (ex UK) index over the long term.*	*Funds that aim to generate an absolute return over the medium to long term, i.e. a positive return irrespective of equity or bond market direction.*	*Income producing funds, which are attractive in the context of the yield available from cash, gilts and UK equities.*	*Funds which we believe have the potential to generate a high level of capital growth over the long term.*

KILLIK & Co RESEARCH PERIODIC PUBLICATIONS		
Daily Note	*ETFs Bulletin*	*Thematic*
A summary of the day's newsflow and an update of opinion on covered stocks.	*Focusing on London-listed Exchange Traded Funds (ETFs) and Exchange Traded Commodities (ETCs).*	*A number of direct equity and fund ideas that are well positioned to exploit a key investment theme.*

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