

# Off Wall Street

## Consulting Group, Inc.

P.O. Box 382107  
Cambridge, MA 02238

tel: 617.868.7880

fax: 617.868.4933

internet: [research@offwallstreet.com](mailto:research@offwallstreet.com)

[www.offwallstreet.com](http://www.offwallstreet.com)

All information contained herein is obtained by Off Wall Street Consulting Group, Inc. from sources believed by it to be accurate and reliable. However, such information is presented "as is," without warranty of any kind, and Off Wall Street Consulting Group, in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness, or completeness of any such information or with regard to the results to be obtained from its use. Off Wall Street has strict policies prohibiting the use of inside information. We have also implemented policies restricting the use of experts. Among other things, Off Wall Street: (1) does not hire expert networking firms; (2) does not hire as experts employees of those companies we research; and (3) specifically instructs consultants whom we hire to not provide us with inside information. All expressions of opinion are subject to change without notice, and Off Wall Street Consulting Group, Inc. does not undertake to update or supplement this report or any of the information contained herein. You should assume that Off Wall Street Consulting Group, Inc. and its employees enter into securities transactions which may include hedging strategies and buying and selling short the securities discussed in its reports before and after the time that Off Wall Street Consulting Group, Inc. determines to issue a report. Off Wall Street Consulting Group, Inc. hereby discloses that its clients and we the company, or our officers and directors, employees and relatives, may now have and from time to time have, directly or indirectly, a long or short position in the securities discussed and may sell or buy such securities at any time.

### Copyright 2013 by Off Wall Street Consulting Group, Inc.

N.B: Federal copyright law (Title 17 of the U.S. Code) makes it illegal to reproduce this report by any means and for any purpose, unless you have our written permission. Copyright infringement carries a statutory fine of up to \$100,000 per violation. We offer a reward of \$2,000 for information that leads to the successful prosecution of copyright violators.

**New Rec: Spirit AeroSystems (SPR: \$16.96) February 12, 2013**

**Position: Buy**

**Target: \$24.75**

\$Mil	Q412	Q113e	Q213e	2012	2013e	2014e	2015e
Rev	1,426	1,385	1,474	5,398	5,934	6,413	6,663
EPS\$	0.47	0.49	0.53	1.41	2.17	2.50	2.76
Y/Y	0%	-14%	-11%	n/a	n/a	15%	10%
PE	n/a	n/a	n/a	11.9	7.8	6.8	6.1
PSR	n/a	n/a	n/a	0.6	0.5	0.5	0.5
Cons.	n/a	n/a	n/a	n/a	2.12	2.38	n/a
P/TBV	n/a	n/a	n/a	1.2	1.1	0.9	0.8

**Shares Out: 142M**

**Market Cap: \$2.4B**

**FYE: December**

Concept:

1. SPR is inexpensive (7.8x EPS) and misunderstood. Investors are discounting substantial future losses on SPR's development programs, a view with which we disagree.
2. SPR has a \$35B backlog (~7 yrs.), virtually all from existing contracts. This creates high earnings visibility.
3. SPR's core business is growing and generates estimated FCF of ~\$2.67.
4. The core business should continue to grow with strong global aircraft demand. The combined backlogs of Boeing and Airbus are 7x current annual production.
5. Replacement value of SPR's assets far exceeds current market valuation. This should provide a substantial margin of safety. TBV is \$14.06, or 84% of current MV.

Summary: Spirit AeroSystems (SPR) is the former aerostructures division of Boeing. It was acquired in 2005 by an investment group led by Onex Partners. Shortly thereafter, Onex acquired the aerostructures division of BAE systems, a major supplier to Airbus. The two companies were subsequently combined and taken public in 2006. Total revenue was \$5.4B in 2012, 99% of which is non-defense related.

SPR shares have declined markedly following a sizable (and surprise) charge in Q312 for cost overruns in several of its development programs. In our view, this has created a compelling opportunity for long-term investors to purchase a key supplier of critical structures to the world's two largest aircraft manufacturers. Investors appear concerned about substantial additional development charges. There is also concern surrounding current negotiations with Boeing regarding a key contract that expires in June 2013. As we discuss in the report, we think these concerns are well known and more than discounted into SPR's current valuation. Moreover, the Q312 loss charges had a "kitchen sink" complexion and should pave the way for reduced future risk within the development programs.

Another concern involves the safety risk of the new Boeing 787. Following two incidents involving the aircraft's lithium ion battery, all 50 of the 787s in service have been temporarily grounded. As we discuss in the report, we expect the 787 to be flying again by August at the latest, with little effect on SPR's production schedule. Any extended grounding would likely result in compensation to SPR should production be delayed. Investors should note that SPR books a \$0 profit on its initial contract block (through Q3 2016). We think the negative news surrounding the 787 provides additional opportunity to purchase SPR shares.

SPR has experienced a volatile history as a public company. The shares traded as high as \$41 (5.5x TBV at the time) but have never been able to maintain the gains for long. Investors and sell-side analysts have been burned repeatedly by

negative announcements regarding development programs. For instance, SPR endured a 3-year delay of the launch of the Boeing 787 Dreamliner, after having invested substantial upfront capital. It has also experienced considerable cost overruns on the new Gulfstream jets. Thus, we are not surprised by the strong negative reaction following the recent charges. However, while we recognize that there remains additional potential risk to SPR, we view the risk-reward equation to be compelling given the current depressed valuation and extremely negative investor sentiment.

In our opinion, investors are not viewing SPR through the correct lens. The key to our thesis is the inherent value within SPR's core business, which produces complex fuselage, propulsion and wing components for the Boeing 737-777 and the Airbus 320-380 aircraft families. Most of these programs have been in place for decades and have well-established cost structures and predictable long-term revenue streams. SPR's core business is highly profitable and growing. Core revenue increased 12.5% y/y in 2012. It also generates substantial free cash flow. We estimate that the core operation generates annual FCF of ~\$2.50 and could approach \$3.00 in 2014 as production rates continue to increase in line with global demand for aircraft.

SPR's business has an extremely long duration with individual programs typically extending 20-30 years. Its structural components, in particular the forward fuselage and nacelle are among the most complex and highly engineered components and represent a significant % of the cost of each aircraft. SPR is a key supplier to the top-selling commercial jet platforms of Boeing (BA) and Airbus (for the life of each product), which have a current combined backlog of 8,400 planes, 98% of which SPR supplies primarily on a sole-source basis. SPR has a strong incumbent position forged by long-standing relationships and LT supply agreements with Boeing. Moreover, there are enormous switching costs to change suppliers once contracts are awarded.

Although the core business is flourishing, SPR's earnings (and FCF) are being masked by the heavy upfront design, development and early production costs associated with new programs. These are large consumers of cash during the development stage and in the early years of production. As a result, SPR has reported negative FCF for several years to the frustration of investors. However, investors should understand that SPR's development programs are extremely long-tailed. For example, Boeing expects to produce the 787 (+ any future derivative versions) for the next 25+ years with SPR supplying the forward fuselage (including a fully equipped cockpit), engine pylons and certain wing components. Thus, as unit production increases (to an eventual target of 10/month) and as SPR

migrates along the production learning curve, cash unit costs should continue to decline and cash flow should surge. As evidence, in Q412, deferred production costs (which represent negative cash flow) were \$1.1M per unit shipped compared with \$4M/unit in Q411 and \$14M/unit for all of 2010. We expect the total initial contract block will be cash generative, which implies strong FCF for the 787 over the 2013-2016 timeframe. Moreover, subsequent production blocks, which do not include the heavy upfront development costs, should result in many years of strong profits and cash flow for SPR. Short-term investors appear to be misinterpreting the long-term economics of the 787 program.

SPR is also a key supplier to the Gulfstream G-650 and G-280 business jets, which received type certification in September 2012 and have entered full production. In retrospect, management bid far too aggressively for this contract, which was its first foray outside of Boeing and Airbus, and appears to have overestimated the rate at which it could reduce costs. This has resulted in substantial forward-loss charges, the largest of which took place in Q312. We note that 70% of all SPR's charges relate to the Gulfstream programs. However, we think that any potential future losses from Gulfstream are sufficiently reflected in SPR's depressed valuation. While we expect SPR to meaningfully reduce unit costs over the coming years (fixed cost leverage + better purchase economics), our recommendation does not rely on Gulfstream generating positive cash flow. In fact, to be conservative, we ascribe a negative value (~\$320M) to the Gulfstream contract and we think SPR should consider exiting the program, perhaps by enabling Gulfstream to bring production in-house.

Following the Q412 earnings release, SPR shares rallied 5%. Based on an average of our 2013 and 2014 forecasts, SPR shares remain unusually cheap at 4.3x EBITDA and 7.4x EPS. These are well below similar multiples of other aerospace suppliers. We view SPR as a misunderstood deep-value play with a compelling risk reward equation. At the current valuation, there appears to be a considerable margin of safety, although we note the potential for headline-driven price volatility. To begin with, TBV is \$14.06 and should increase to \$16 by the end of 2013 or about 1.1x the current share price. The balance sheet is solid with \$440M in cash and a net debt/EBITDA ratio of 1.1x. Moreover, the estimated replacement cost of SPR's equipment and buildings far exceed the current market valuation. Lastly, there is ~\$1B (\$5/share a/tax) in "excess" development inventory that should produce future cash flow for SPR.

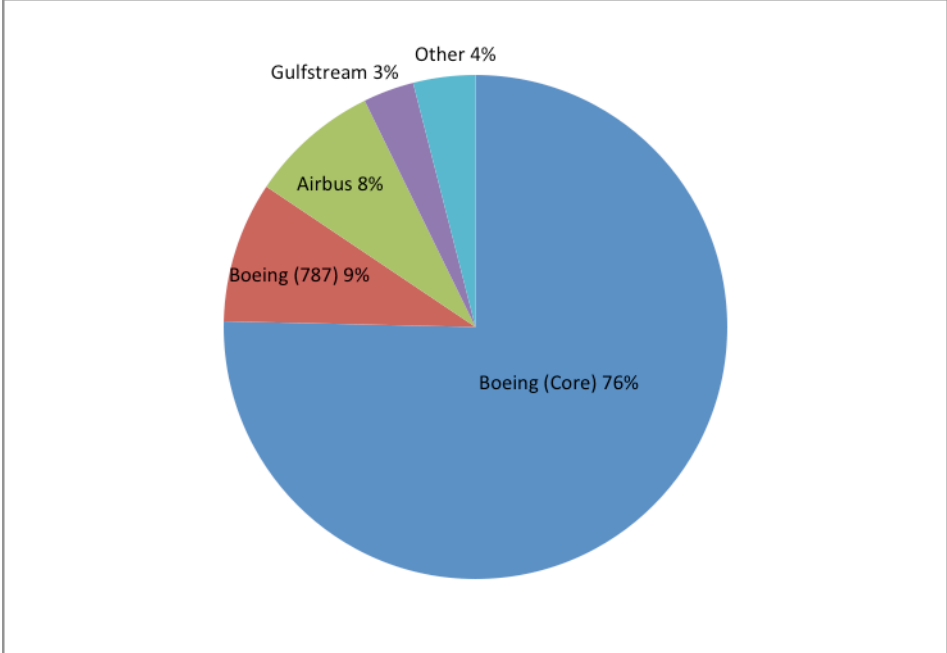
We think the most logical way to value SPR is to view the company as two separate profit streams: the core business and the development programs. Based on our estimate of the 2013 core (fully-taxed) FCF of \$2.70 and a conservative

multiple of 10x, we arrive at a value for SPR’s core business of \$27. From that we subtract \$320M or \$2.25/share for our estimate of the net (negative) value of SPR’s development programs, which is driven largely by the Gulfstream contracts. We ascribe little combined value to SPR’s 787 and A-350 programs. The result is a per share valuation of \$24.75, which we have established as our initial price target. This implies upside of 47%. Longer term, there could be meaningful additional upside based on growth in the core business, FCF accretion, potential share repurchases, and better than expected results from development programs. We also view SPR to be an attractive acquisition candidate.

Background:

Spirit AeroSystems (SPR) is one of the world’s largest independent non-OEM suppliers of commercial aircraft assemblies and components. The company designs and manufactures fuselages, pylons, nacelles and wing components and possesses expertise in both aluminum and composite materials. It also provides aftermarket support services including maintenance/repair/overhaul and spare parts. SPR has exclusive long-term agreements with Boeing and Airbus, which account for the majority of its \$5.4B annual revenue. We detail the revenue mix in Table 1.

Table 1: SPR revenue mix by customer



SPR’s core operations were a former operating unit of Boeing (Boeing Wichita/Tulsa) for 75 years. In June 2005, Canadian private equity firm Onex Corporation acquired the Wichita/Tulsa manufacturing unit from Boeing for

~\$1.5B. This unit manufactures aerostructures for all currently-in-production Boeing commercial aircraft (737-787 models). In April 2006, SPR acquired BAE Aerostructures from BAE Systems for \$204M. The business is based in Scotland and manufactures leading and trailing wing edges and other aerostructure components primarily for Airbus. Onex took SPR public in a November 2006 IPO (at \$26). Onex currently owns 11% of SPR's outstanding common shares and 62% of the total voting rights. SPR is headquartered in Wichita, Kansas and has more than 15,000 employees worldwide.

#### Discussion:

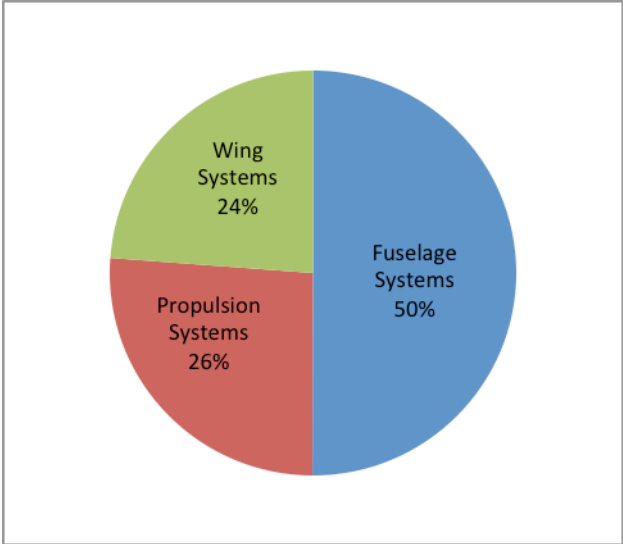
1. SPR shares have declined markedly following substantial loss charges that the company booked on its development programs in October 2012. The timing and magnitude of the charges appear to have been a surprise to investors, who are concerned that these programs will continue to burn considerable cash and result in additional charges. As we discuss below, we think any negative fallout from SPR's newer programs have been sufficiently discounted into the current valuation and that there is considerable upside to the share price.

The main focus of our recommendation is on SPR's "core" business, which we estimate to be worth far more than the current market valuation. This business, which is comprised of the non-development programs, manufactures critical aerostructures for Boeing commercial aircraft (737-777). SPR supplies the fuselage, propulsion systems, and various wing components to Boeing, which it has been partnering with for many decades. SPR also supplies similar aerostructures for the Airbus A-320 family of aircraft. We detail core revenue by component in Table 2.

Excluding the Boeing 787, which (for the near term) we categorize as a development program, we estimate SPR's 2012 core revenue at \$4.6B. During a recent conference appearance, management noted that in the core business, productivity was at the best level ever and that FCF was exceeding the company's plan. Based on our analysis of the development programs, SPR's corporate filings, and discussions with management, we estimate SPR's core FCF to be in the range of \$2.30-\$3.00 per share. Applying a conservative multiple of 10x to our estimated 2013 FCF of \$2.70 suggests a value of \$27 for SPR's core business. A group of peer companies trades at an average of 13x forward earnings. We point out that SPR's share price reached \$41 in 2007 when the core business was much smaller, but before the current development programs were fully launched. We also expect the 787 program to turn cash flow positive in Q114, at which point we would

consider it to be part of the core business. In fact, including the 787, we forecast SPR's core revenue to reach \$6.3B in 2015 (93% of total revenue) with core FCF of ~\$3.18.

Table 2: Core revenue mix by component type



SPR's core business should benefit from several long term trends. These include forecasted growth of global commercial passenger miles (especially in emerging markets). Moreover, there is a need to replace thousands of inefficient, out-of-production aircraft with newly designed fuel efficient ones based on compelling economics and a rapid return on investment. As evidence, Boeing and Airbus have a combined backlog of 8,400 commercial aircraft, 98% of which are supplied by SPR. This is reflected in SPR's current backlog of \$35B or about 7 years of revenue. In 2012, Boeing's commercial deliveries (excluding the 787) increased 17% to 555 aircraft and it is forecasting deliveries of 635-645 for 2013.

2. If we look at the delta between our estimated value for SPR's core business (\$27) and the current share price (\$16.96), there appears to be a considerable disconnect, which forms the basis for our recommendation. In our view, investors are essentially pegging the discounted present value of SPR's development programs at a negative \$1.4B, as we highlight in Table 3. Moreover, if we consider SPR's deferred production inventory and capitalized pre-production inventory, which are detailed in Table 4, the delta between perception and reality becomes even greater, or roughly \$2.2B.

Does this suggest that the market is anticipating an additional \$2.2B in cash burn or loss charges? For that to have any merit, SPR's development unit costs would not only have to stop declining, but they would have to increase markedly in

the future. We think this is a highly inaccurate assumption. In fact, based solely on volume driven fixed-cost leverage, we expect development program unit costs to decline meaningfully over the next several years. It is also important to note that nearly 80% of all charges to SPR development programs are attributable to the wing division, much of which relates to the Gulfstream program.

Table 3: Implied value of development programs (\$mil)

2013e Core FCF	\$2.70
Multiple	10.0
Per-share value of SPR "core" business	27.00
Current SPR share price	16.96
Implied per-shr value of development programs	(10.04)
FD shares	142.7
Implied value of development programs	(1,433)
After-tax "excess" inventory	753.5
Net implied value of dev. programs	(2,186)

At 12/31/12, SPR's development programs had deferred production inventory (DPI) of \$1.17B. Capitalized pre-production inventory was an additional \$525M for a total of \$1.7B. Subtracting the forward loss charge (\$607M) results in a net combined "excess" inventory of \$1.1B. This represents cash already spent on development and production that is factored into the company's future average cost estimates. Thus, if "current" cost assumptions are accurate, this \$1.1B should represent a meaningful source of future cash flow. Viewed from another angle, if SPR were to take an additional \$1.1B in forward loss charges (a highly unlikely scenario), excess inventory would be reduced to \$0 yet the development programs could still be cash flow neutral over their initial production blocks. We await the 10K for a more detailed breakout by program.

Table 4: "Excess" development inventory (\$mil) \*

Deferred production inventory	1,174.0
Capitalized pre-production	525.0
Forward loss provisions	(607.0)
Net "excess" inventories	1,092.0
net of tax	753.5
per SPR share	\$5.31

\* 12/31/12



Moreover, while investors fret about potential negative cash flow in SPR’s development programs, they are ignoring the fact that the core business continues to generate ample FCF. The core business should generate another ~\$1.1B in FCF over the next 3 years as we highlight in Table 5. This should dwarf any negative FCF from development programs over the same period. Moreover, the cash flow dynamics become increasingly compelling with time.

Table 5: Net cash flow 2013-2015 (\$mil)

Core business	1,137.4
G-650 program	(229.8)
Boeing 787 program	214.1
A-350, G-280, other	(348.0)
Total FCF 2013-2015	773.7
per SPR share	5.45
Net development pretax CF 2013-2015	(363.7)
per SPR share	(2.56)

3. We think investors do not fully comprehend the extremely long-term nature of SPR’s aircraft programs. Its business model is generally comprised of a 4-6 year non-recurring investment period, which includes design and development, followed by 15-30 years of production. The non-recurring periods require significant outflows of cash as SPR designs the product, builds tooling, purchases equipment and builds initial production inventories. One industry insider referred to the business as “losing money upfront to gain access to a 30-year cash coupon”.

Nevertheless, SPR’s development programs continue to be a significant near-term cash drain and are weighing on the company’s valuation. It is important to understand, however, that most of the negative cash flow stems from the way in which the contracts are structured. SPR recognizes revenue under the contract method of accounting (units of delivery method), a complete description of which can be found in SPR’s 10K report. SPR’s recurring long-term production contracts are divided into contract blocks with each block treated as a separate contract for accounting purposes. A profit rate for each block is estimated based on the difference between total projected revenue and cost. Costs include the estimated cost of certain pre-production efforts plus the estimated cost of manufacturing a specific number of production units. Estimates include assumptions about future labor performance and rates, material and overhead costs including expected

learning-curve cost reductions over the term of the contract. Estimates of profit margins on each contract block are reviewed quarterly and adjusted accordingly.

SPR's core business is typically structured using smaller short-term contract blocks (~2-3 years) given recent cost history and probable forecast accuracy. However, for the newer (development) programs, the initial contract blocks require a longer time period and greater number of units in order to allow for the higher cost of early units due to a steeper experience curve and significant pre-production design/engineering costs. Not surprisingly, during the early years of an initial block, cash flow is often negative.

Inventoried cost attributed to units delivered under SPR's long-term contracts are based on the estimated average cost of all units expected to be produced (within a block) and are determined under the learning curve concept. This concept anticipates a predictable decrease in unit costs as tasks and production techniques become more efficient through repetition. This typically results in an increase in inventory (referred to as excess-over-average or "deferred production costs") during the early years of a contract, which results in significant negative cash flow.

4. SPR accounts for both the 787 and Gulfstream programs at a \$0 profit over their respective initial contract blocks. However, management expects both contracts to be solidly cash flow positive over their respective initial contract blocks, a perspective that differs markedly from the implied valuation in SPR's current share price. Although we share a similar outlook for the 787, our viewpoint on Gulfstream is far more conservative than that of the company.

For the 787 program, investors appear to be confusing the profitability and cash flow dynamics of the initial contract block with the probable long-term results of the total contract. Recall that for nearly 40 years, SPR has been manufacturing components for the Boeing 737, from which it has generated substantial recurring profits and cash flow. For the new 787, SPR is the exclusive supplier of the forward section fuselage, wing leading edge, and engine pylons for the life of the aircraft including any future derivative models. Boeing anticipates producing thousands of the 787 family aircraft over the next 25+ years including the introduction of the larger 787-9 and 787-10 models over the next several years.

For SPR, the initial contract block on the 787 equals 500 shipsets expected to be delivered through Q3 2016. Through 2012, an estimated 99 units (or full shipsets) have been delivered by SPR to Boeing. Thus, SPR is still relatively early

on the production learning curve resulting in higher than average cash unit costs. It also has absorbed significant design and development costs, which are reflected in capitalized prepaid inventory. Most importantly, SPR was producing just 3 units per month through Q312 and produced 5/month in Q412. This compares to an eventual target rate of 10/month. Therefore, fixed costs are being spread over a small number of units, which results in high unit costs and negative cash flow on the 787 program. However, there is tangible evidence that unit costs have improved consistently. In the most recent quarter (Q412), SPR delivered 15 shipsets for the 787. Based on the reported change in deferred production inventory (DPI) of \$17M, there was a cash burn of \$1.1M per shipset in Q412. This compares to \$4M/unit in Q411 and ~\$10M/unit in Q410.

Based on the company's well established learning curve history, we expect total cash unit costs to reach breakeven in early 2014. Even if we assume no further improvements in variable unit costs (highly unlikely), total unit costs should decline based solely on the leveraging of fixed overhead costs. For example, assuming fixed overhead of 20%, we estimate SPR would reach cash breakeven on the 787 at a production rate of 6-7 units per month. In our view, it seems highly improbable that the 787 program would be meaningfully cash flow negative on a cumulative basis over the initial production block of 500 planes. Most importantly, we forecast SPR's 787 program to generate FCF of \$385M over the 2013-2016 timeframe. And it should generate strong profits and cash flow on subsequent production blocks since production costs would be well established and there would be little upfront investment in design and tooling.

As we stated previously, the Boeing 787 was temporarily grounded on 1/16/13 due to concerns about the safety of the aircraft's lithium ion battery system. Our forecasts assume that the 787 is cleared to resume flying by August of this year at the latest. A longer delay would result in fixed-cost deleveraging for SPR and reduced near term cash flow, although it appears that the Boeing contract allows for compensation under such circumstances. Based on the most recent comments from the FAA, NTSB and several major airlines that are awaiting 787 deliveries, it is clear that any safety issues relate directly to a short-circuit in the lithium ion battery and not any structural part of the aircraft. While the timing is uncertain, we believe the issue is readily fixable. The CEO of International Consolidated Airlines Group (IAG), a major 787 customer (24 planes), recently stated the following: "based on confidential information we have been given, Boeing will have to do some redesign of the battery system and I would expect it to take a couple of months...IAG remains committed to its orders for the 787 and is confident Boeing will sort out the problem." We believe the most likely scenario

is that Boeing will have to change/re-engineer the battery system, which could take up to 6 months. However, since SPR currently accounts for its 787 shipments at a \$0 profit, we see minimal risk to near-term earnings.

5. SPR's other major development program is its Gulfstream program, which has been the most problematic part of the SPR story and the main concern of investors. It is important to note that Gulfstream has accounted for 70% of the cumulative charges taken by SPR over the past 3 years. When SPR negotiated the initial contract (valued at ~\$2B in expected revenue), it represented its first foray outside of the core Boeing/Airbus business. In retrospect, SPR bid far too aggressively for the contract, which has resulted in substantial losses to date, including a \$402M forward-loss charge in Q312, 80% of which was attributed to the G-650. This was followed by a \$20M charge in Q412 for the G-280 program. SPR produces wing components and engine nacelles for the G-650 and makes wing components for the G-280, a much smaller contract. The G-650 is a state of the art ultra-luxury business jet that carries a price tag of \$65M. Gulfstream, which is owned by General Dynamics, delivered its first fully-outfitted unit in December 2012. For the G-650, SPR's initial contract block consists of 350 units through 2018, 40 of which have been delivered as of yearend 2012.

In September 2012, both jets received type certification, which enabled the aircraft to enter service. While this prevents any additional cost reductions on the design and engineering phase, there is a well-documented history of aerospace companies reducing unit costs when moving from development into full production. Although our forecasts incorporate meaningful unit cost reductions over the next several years, we have forecast a very conservative outlook for the G-650 program. More specifically, we have modeled a negative cumulative cash flow over the initial 350-block, much of which is front loaded in years 2011-2013. For the 2013-2016 timeframe, which includes our primary investment horizon for SPR, we estimate the combined G-650/280 programs will generate negative cash flow of \$330M, although this should improve progressively, becoming cash flow positive in 2016 and generating substantial cash in 2017 and 2018. We also believe that management significantly de-risked the Gulfstream program when it booked total charges of \$422M in the latter half of 2012. Thus, our forecast could prove to be conservative.

6. SPR is also a supplier to the next generation Airbus commercial jet, the A-350 XWB (extra-wide body), which is positioned as a fuel-efficient competitor to the Boeing 787. The A-350 will be the first Airbus plane with both fuselage and wing structures made primarily of carbon fibre-reinforced polymer. It will carry 250-350 passengers and is scheduled to enter service in the latter part of 2014.

SPR has 4 separate contracts covering the A-350: 2 non-recurring development contracts (wing and center fuselage); and 2 recurring production contracts. These contracts incorporate a higher level of risk sharing. Unlike the 787 contract, SPR will receive payments from Airbus prior to Airbus delivering the plane to a customer. The company learned a painful lesson when the 787 was delayed for several years putting financial strain on SPR, which had not received payment despite spending considerable capital on development. SPR produces the A-350 components in its North Carolina facility from where they are shipped to France for finishing and delivery to Airbus. These are straightforward structure-only hardware components (no systems). Like all new programs, the A-350 will be a cash user until it gets well into the production phase. SPR delivered 1 shipset in Q412.

SPR is also a key supplier on the Boeing 737 Max, the next-generation 737 aircraft, which is expected to enter service in 2017. As we discussed earlier, SPR has supplied the 737 for decades. According to management, Boeing's choice to re-engineer the 737 was the best outcome for SPR since it will utilize essentially the same fuselage and installed tooling. This should save at least \$1B in capex for SPR. According to Boeing, there have been more than 1,060 orders to date.

7. SPR has a relatively healthy balance sheet. At 12/31/12, cash was \$441M and debt was \$1.18B. Net debt of \$735M equates to roughly 1.1x TTM EBITDA. The company has a \$550M term loan that matures in 2019. It also has \$600M in senior notes, \$300M of which mature in 2017 and \$300M in 2020. And there is a \$650M revolving credit facility that remains undrawn. Shareholders' equity is \$2B with TBV of \$14.06. It is important to note that a large % of SPR's assets consist of high quality inventory built for existing aerospace programs. Moreover, according to the most recent 10K, the combined insurable replacement value of SPR's buildings and equipment is approximately \$5.8B. If we exclude non-owned equipment, the net replacement value would be \$4B or about \$28 per SPR share. SPR also has a fully funded pension plan.

Although the core FCF has been strong over the past several years, SPR has reported persistent negative cash flow due to the previously discussed development programs. As we highlight in Table 6, we expect SPR's development cash flow to remain negative over the 2013-2015 timeframe, although with a progressively improving trend, especially as the 787 ramps up production. Recall also that SPR has substantial "excess" inventory that should eventually generate strong cash flow.

Table 6: Free cash flow

	2011	2012	2013e	2014e	2015e	2016e
Core revenue (ex 787)	4,160.1	4,677.0	4,835.7	4,900.7	4,922.0	4,950.8
Core FCF per share	343.2 2.42	385.9 2.72	398.9 2.80	416.6 2.92	428.2 3.02	430.7 3.03
Reported FCF	(296.5)	183.6	19.5	191.8	303.3	355.0
Development FCF	(639.7)	(202.2)	(379.4)	(224.7)	(124.9)	(75.7)

8. There are a number of risks to an investment in SPR. The main risk, in our view, is a severe global economic downturn that negatively impacts commercial aircraft demand. There is also a risk of a failure to achieve incremental unit cost reductions within SPR's development programs. Moreover, SPR is currently in negotiations with Boeing concerning pricing for the base 737 contract, SPR's largest contract, which is scheduled to expire in June 2013. However, we note that the "interim pricing" clause of the existing contract provides for existing pricing to continue (with scheduled escalations) until a new agreement is reached. Lastly, major safety concerns involving any aircraft supplied by SPR could impact demand for that particular aircraft, including the aforementioned Boeing 787, which has yet to resolve its battery issue.

## 9. Recent results

In the most recently reported quarter (Q412), total revenue increased 17% to \$1.4B led by strong growth in core deliveries and a ramp up in several development programs. In the Fuselage segment, revenue increased 16.8% to \$680M. The EBIT margin was 13.6%. In Propulsion Systems, revenue increased 14.4% to 368M. The EBIT margin was 13.0%. In Wing Systems, revenue increased 19.7% to \$375M. The EBIT margin was 5.2%. All segments were negatively impacted by forward loss charges, the largest of which was a \$20M charge for the G-280 wing program. This was partially offset by a favorable catch up adjustment of \$10M in the core business. Core revenue (excluding the 787) was \$1.2B, up 10% y/y.

Total gross margin was 12.4% vs. 14.7% in Q411. SG&A + R&D expenses increased a combined 17% to \$58.8M or 4.1% of revenue. This resulted in adjusted EBIT of \$118M or 8.3% of revenue. Net interest expense increased 12% to \$20M. Using a tax rate of 31% and 142.7M FD shares, EPS was \$0.47 vs. \$0.53 in Q411. This includes the aforementioned charges. At 12/31/12, cash was \$441M and total

debt was \$1.17B. Net debt was \$736M or 1.0x EBITDA. TBV is \$14.06.

## 10. Financial assumptions

Our revenue estimates are derived from our model of individual aircraft deliveries and revenue per shipset estimates. For 2013, we estimate total revenue to increase by 9.8% to \$5.9B. This is driven by the following: fuselage revenue +10% to \$2.85B; propulsion revenue +9.4% to \$1.55B; wing system revenue +10.1% to \$1.5B. Next we estimate segment EBIT margins as follows: fuselage 14.1% vs. 14.6% in 2012; propulsion 14.4% vs. 14.6%; wing systems 4.8% vs. 2%. EBIT margins are negatively impacted by expected growth in the 787 and Gulfstream contracts, both of which are booked at a 0% margin. Unallocated corporate expense should increase from \$160M to \$180M in 2013, resulting in EBIT of \$521M or 8.8% of revenue. Net interest expense should increase to \$74M vs. \$72M. Using a tax rate of 31%, operating EPS should be \$2.17 in 2013. Adjusted EBITDA is estimated at \$692M.

For 2014, we estimate total revenue to increase by 8.0% to \$6.4B. This is driven by the following: fuselage revenue +13% to \$3.2B; propulsion revenue +5.5% to \$1.6B; wing system revenue +2% to \$1.52B. Next we estimate segment EBIT margins as follows: fuselage 14.0%; propulsion 14.5%; and wing systems 5.5%. SG&A and R&D combined should increase by 7.5% or to 3.8% of revenue. Unallocated corporate expense should increase to \$191M, resulting in EBIT of \$585M or 9.1% of revenue. We note that management's longer term EBIT margin objective is 12%. Net interest expense should decline slightly to \$70M. Using a tax rate of 31%, operating EPS should be \$2.50 in 2014, an increase of 15% y/y. Adjusted EBITDA is estimated at \$767M. At yearend 2014, we estimate net debt to be \$582M or roughly 0.8x EBITDA. TBV should be \$18.24. Our estimates assume modest (\$50-75M) additional loss charges in SPR's development programs across 2013-2014.

11. SPR shares have rebounded by ~14% since we first began working on the idea, including a 5% gain following yesterday's earnings report. Nonetheless, as we discussed in detail in the report, SPR shares remain inexpensive on an absolute basis and also relative to peers and historical valuation. Sentiment remains poor following significant loss charges in Q312 and the recent safety issues surrounding the Boeing 787. In our view, SPR is misunderstood and should receive a re-rating as the inherent value of the core business becomes more apparent to investors. Importantly, we think there is a substantial margin of safety given the company's cheap valuation, considerable backlog, strong asset base and ample underlying

FCF. Thus, we view the risk reward to be compelling.

There are also several potential positive catalysts, none of which our valuation is dependent upon, that could drive SPR shares higher over the next 1-2 years. First, the company could announce a new CEO in the immediate future. We believe it has been searching for a solid hands-on operating person who would also make shareholder interests a top priority, including improving the manner in which the company communicates with investors. We also anticipate a conclusion to the Boeing contract negotiations, which has been an overhang on the share price, and we see the possibility that SPR could realize a better than expected outcome. Next, we think that any progress on the Gulfstream contract (better cost achievements, a renegotiation or even an outright exit) could cause the share price to rise. Other catalysts could be the approval for the 787 to resume flying and the achievement of cash breakeven on the 787 program. Finally, given the marked decline in the share price, we think that key shareholders could agitate for change or perhaps an outright sale of the company, although that is not a core part of our thesis. We estimate SPR's private market value to be between \$26 and \$31 based on several recent transactions.

Our price target for SPR is \$24.75, derived using the sum of our valuation for the core business and the development programs. Our view of the development programs is conservative. This suggests potential upside of 46%. Downside should be limited (~15%) based on the strong assets, core FCF and low valuation. At our price target (based on our 2014 estimates), SPR would be valued at 9.9x EPS, 5.6x EBITDA and 1.4x TBV.



## 12. Financial projections

a. annual projections	2010	2011	2012	2013e	2014e	2015e
Fuselage Systems	2,035.1	2,425.0	2,590.6	2,849.7	3,231.3	3,443.5
Propulsion Systems	1,061.8	1,221.5	1,420.9	1,553.9	1,638.6	1,679.5
Wing Systems	1,067.4	1,207.8	1,375.1	1,518.4	1,531.3	1,525.0
Other	8.1	9.5	11.1	12.0	12.0	15.0
Total revenue	4,172.4	4,863.8	5,397.7	5,934.0	6,413.3	6,663.0
Cogs	3,576.4	4,181.7	4,830.8	5,181.6	5,579.5	5,773.9
Gross profit	596.0	682.1	566.9	752.4	833.7	889.1
SG&A	156.0	159.9	172.2	188.0	200.0	207.0
R&D	51.5	35.7	34.1	42.8	48.0	51.0
EBIT	388.5	486.5	360.6	521.6	585.7	631.1
Interest expense, net	59.0	77.0	72.8	73.8	70.0	64.0
Other income (exp)	0.0	0.0	3.5	0.0	0.0	0.0
Pretax income	329.5	412.1	291.2	447.8	515.7	567.1
Income tax	102.1	127.8	90.3	138.8	159.9	175.8
Net income	227.4	284.3	200.9	309.0	355.8	391.3
EPS	\$1.61	\$2.00	\$1.41	\$2.17	\$2.50	\$2.76
Average shares	141.0	142.0	142.0	142.7	142.6	142.0
EBITDA	516.5	629.1	536.2	692.5	766.5	829.3
TBV	12.75	13.84	14.06	15.95	18.24	20.85
% of sales						
Gross margin	14.3%	14.0%	10.5%	12.7%	13.0%	13.3%
SG&A	3.7%	3.3%	3.2%	3.2%	3.1%	3.1%
R&D	1.2%	0.7%	0.6%	0.7%	0.7%	0.8%
EBIT	9.3%	10.0%	6.7%	8.8%	9.1%	9.5%
Interest expense, net	1.4%	1.6%	1.3%	1.2%	1.1%	1.0%
D&A	3.1%	2.9%	3.3%	2.9%	2.8%	3.0%
EBITDA	12.4%	12.9%	9.9%	11.7%	12.0%	12.4%
Tax rate	31.0%	31.0%	31.0%	31.0%	31.0%	31.0%
Net income	5.4%	5.8%	3.7%	5.2%	5.5%	5.9%

Y/Y % chg	2010	2011	2012	2013e	2014e	2015e
Fuselage Systems	1.6%	19.2%	6.8%	10.0%	13.4%	6.6%
Propulsion Systems	3.1%	15.0%	16.3%	9.4%	5.5%	2.5%
Wing Systems	4.2%	13.2%	13.9%	10.4%	0.9%	-0.4%
Other	-60.5%	17.3%	16.8%	8.1%	0.0%	25.0%
Total revenue	2.3%	16.6%	11.0%	9.9%	8.1%	3.9%
Gross profit	-0.8%	14.4%	-16.9%	32.7%	10.8%	6.6%
SG&A	13.8%	2.5%	7.7%	9.2%	6.4%	3.5%
R&D	-9.2%	-30.7%	-4.5%	25.5%	12.1%	6.3%
EBIT	-4.6%	25.2%	-25.9%	44.6%	12.3%	7.7%
Interest expense, net	59.5%	30.5%	-5.5%	1.6%	-5.4%	-8.6%
Pretax income	-11.0%	25.1%	-29.3%	53.7%	15.2%	10.0%
Income tax	-11.0%	25.1%	-29.3%	53.6%	15.2%	10.0%
Net income	-11.0%	25.1%	-29.4%	53.8%	15.2%	10.0%
EPS	-11.6%	24.2%	-29.4%	53.1%	15.2%	10.4%
Average shares	0.7%	0.7%	0.0%	0.4%	0.0%	-0.4%

(amounts in \$000, except ratios)

Current debt	1,165,900
Current Equity	1,996,900
Current tangible BV	1,996,900
Current market value	2,399,800
Current cash	440,700

Current DSO	27
Current DIO	154

FYE December	2012	2013e	2014e
EBIT	360,634	521,633	585,724
EBITDA	536,195	692,546	766,527
Free cash flow	183,639	19,505	191,850
Surplus cash flow (NI+D&A - capex)	138,439	144,505	301,850
Capex	248,800	350,000	250,000
EV/EBITDA	5.8	4.5	3.8
EV/(EBITDA-capex)	10.9	9.2	5.7

b. quarterly projections	Q112	Q212	Q312	Q412	Q113e	Q213e	Q313e	Q413e
Fuselage Systems	622.6	627.4	660.4	680.2	684.9	690.1	726.4	748.2
Propulsion Systems	344.0	351.2	357.6	368.1	371.5	382.8	391.0	408.6
Wing Systems	296.6	358.6	344.6	375.3	326.0	398.0	380.8	413.6
Other	2.6	3.8	2.7	2.0	3.0	3.0	3.0	3.0
Total revenue	1,265.8	1,341.0	1,365.3	1,425.6	1,385.3	1,474.0	1,501.2	1,573.4
Cogs	1,076.6	1,149.6	1,355.7	1,248.8	1,211.2	1,288.3	1,310.2	1,371.8
Gross profit	189.2	191.4	9.6	176.8	174.1	185.7	191.0	201.6
SG&A	45.0	40.3	40.6	46.3	45.0	47.7	47.5	47.8
R&D	7.4	6.9	7.3	12.5	10.2	10.6	10.8	11.2
EBIT	136.8	144.2	(38.3)	118.0	118.9	127.4	132.7	142.6
Interest expense, net	18.3	18.1	16.2	20.2	18.5	18.5	18.3	18.5
Other income (exp)	3.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Pretax income	122.0	126.1	(54.5)	97.8	100.4	108.9	114.4	124.1
Income tax	37.8	39.1	(16.9)	30.3	31.1	33.8	35.5	38.5
Net income	84.2	87.0	(37.6)	67.5	69.3	75.2	78.9	85.6
EPS	\$0.59	\$0.61	(\$0.26)	\$0.47	\$0.49	\$0.53	\$0.55	\$0.60
Average shares	142.0	142.0	143.0	142.7	142.6	142.5	142.5	142.5
EBITDA	172.5	200.2	3.7	159.8	161.4	169.5	177.5	184.0
% of sales								
Gross margin	14.9%	14.3%	0.7%	12.4%	12.6%	12.6%	12.7%	12.8%
SG&A	3.6%	3.0%	3.0%	3.2%	3.2%	3.2%	3.2%	3.0%
R&D	0.6%	0.5%	0.5%	0.9%	0.7%	0.7%	0.7%	0.7%
EBIT	10.8%	10.8%	-2.8%	8.3%	8.6%	8.6%	8.8%	9.1%
Interest expense, net	1.4%	1.3%	1.2%	1.4%	1.3%	1.3%	1.2%	1.2%
D&A	2.8%	4.2%	3.1%	2.9%	3.0%	2.9%	2.9%	2.8%
EBITDA	13.6%	14.9%	0.3%	11.2%	11.7%	11.5%	11.8%	11.7%
Tax rate	31.0%	31.0%	31.0%	31.0%	31.0%	31.0%	31.0%	31.0%
Net income	6.7%	6.5%	-2.8%	4.7%	5.0%	5.1%	5.3%	5.4%