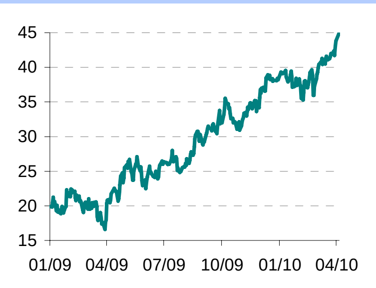
NATIXIS

# MTU AeroEngines

Wednesday, 07 April 2010

## EQUITY DERIVATIVES RESEARCH - Convertible bonds

| Summary Terms | |
|---|---|
| Isin | DE000A0G5NW4 |
| Name | MTU 2.75% 2012 |
| Maturity | 01/02/2012 |
| Outstanding | EU180M |
| Call | |
| Data | 02/15/2010 |
| Trigger/price | 130% - 100% |
| Put | |
| CB ccy | EUR |
| Equity ccy. | EUR |
| **Rating** | |
| S&P : | BB+ / Stable |
| Moody's : | Ba1 / Positive |
| **Equity** | |
| Ticker | DE000A0D9PT0 |
| Name | MTU AeroEngines |
| Market Cap | EU2.28Bn |
| Spot | EU43.8 |
| Reco Natixis | Add |
| Target Price | EU48 |





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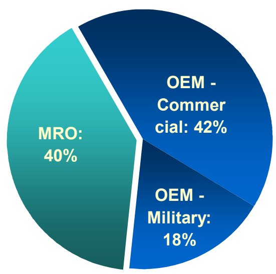
## MTU 2.75% 2012

**- The underlying still harbours potential.**
**- Debt under control, large pension commitments.**
**- Investment Grade rating possible within 12-18 months (Moody's).**
**- We are neutral on the CB as it appears to have little potential.**

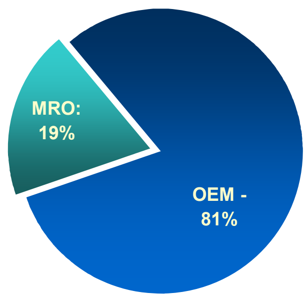
**MTU is 1.) one of Europe's 6 main engine manufacturers (OEM - Original Equipment Manufacturer), mostly working with Pratt & Whitney and GE, and 2.) the biggest independent MRO (Maintenance, Repair & Overhaul) group in the engine segment.** After being sold by Daimler Chrysler to KKR in 2004, MTU was floated in 2005 (100% free float).

### ACTIVITIES

2009 revenues
EU2.61Bn




2009 operating margin
EU292.3M – 11.2%




### 1. OEM (Original Equipment Manufacturer): engines

This business accounts for 60% of sales but over 80% of the margin.
Revenues are split as follows: 70% for **Commercial OEM** and 30% for **Military OEM** (close ties with Germany).
In an effort to reduce its dependence on Pratt & Whitney's projects (2/3 of the group's Commercial OEM sales) and medium-thrust engines, MTU has stepped up its investments in GE's programmes, high-thrust engines (A380) and non-aerospace programmes.

**GTF: technological and financial risks, but a lot of potential.**
MTU devotes much of its investments to Pratt & Whitney's GTF programme (Geared TurboFan, medium-thrust engine). The group says it could generate up to €5bn in revenues, increasing annual revenues by €70/150m per year.
MTU's future therefore depends heavily on this programme, although certain developments by MTU will be applicable to other engines.

**A400M: the last of the unpleasant surprises?**
MTU, which has a 22.2% interest in the engine project, was blamed by Airbus for the major delays on the programme (MTU designs the reactor propulsion software: Fadec).

The group set aside €44.4m in provisions against this programme in 2007 and booked a €90m impairment charge in Q4 09, dragging the engine's present value down to zero.
Management says the provisions booked will be enough to cover any additional costs that may arise in 2010.
In terms of business activity, the market has factored in delayed deliveries (2013/2014 at the earliest) and a reduction in the overall order.

### 2. MRO (Maintenance, Repair, Overhaul): maintenance

MTU generates 35% of its revenues in the USA (vs. 50% a few years ago), with the rest split between Asia (mainly China with the development of the China Southern JV) and Europe.
MTU is looking to reduce the risks in this business, as its production facilities are heavily concentrated in Germany and it is highly dependent on purchases of spare parts from prime contractors (new parts: 55% to 60% of costs).
The group is also highly exposed to short/medium-haul aircraft (60% of MRO revenues) and the V2500 (which powers the A320), the group's top programme: these two contribute 45% of the group's revenues.
Geographical diversification of the client base and improvements in the gross margin generated from spare parts (with repaired parts vs. new parts) will be key factors for this division.

## SHORT/MEDIUM-TERM OUTLOOK: a trough in 2010 prior to a recovery.

**Air transport industry**:
The IATA once again raised its forecasts on 11 March, halving the amount of losses it expects the sector to generate in 2010. Demand is picking up faster than expected, particularly in Asia and Latin America, while Europe and the USA are still lagging.
Ongoing orders for Boeing and Airbus represent 7 years of revenues, and the two aircraft manufacturers should reach their production targets this year. Order cancellations should not be ruled out.

**MTU: 2009 results and 2010 guidance in line**
**OEM**: the division surprised the market positively thanks to the Military OEM segment. The Commercial OEM segment performed in line.
**MRO**: slightly underperformed expectations, with an operating margin of just 6.2% (consensus of 6.8%e) and revenues a little lower than expected.
Net profit came to €141m, in line with the consensus.
FCF reached about €120m, higher than expected (guidance €100m-€120m).
**Backlog**: stable at €4.8bn (1.5 years of revenue).

The 2010 guidance is broadly in line with expectations:
- Stable revenues, EBIT and net profit vs. 2009;
- FCF of €100m.

**2010: revenues set to fall further**
H1 10 should be in line with H2 09: a decline in revenues and margins under pressure. H2 10 will show a recovery depending on traffic and business activity.

**2011: margin gains**
Following the 2010 trough and the negative effects relating to the sector's cycle and product mix, the group's margins should then begin to improve.

**CoE-Concept – Challenge 10**
MTU has set up two programmes aimed at becoming more competitive:
CoE-Concept: a programme to better optimise the group's developments and production, €20m expected as of 2011.
Challenge 2010: a cost-cutting programme launched in 2008, should save €50m per year as of 2011.

**External growth: limited risk?**
MTU confirmed that it does not want to carry out a capital increase, in order to avoid any dilution. This means that any acquisitions will be small. The group should focus on moderately-sized companies in low-cost countries, with a view to improving its cost base.
Potential targets include Sweden's VolvoAero (2008 revenues of €774m), which seems to be of maximal size if a capital increase is to be ruled out. There is less chance that MTU will buy Italy's Avio (2008 revenues of €1.66bn), which has a heavy debt burden and was taken over in 2008 for €2bn by investment funds.

**Speculative appeal: also limited!**
German foreign trade law enables the government to block any offer (from an investor that is not an EU member) for more than 25% of the voting rights of a German company belonging to a 'sensitive' sector.
In the event of an offer, the CB is protected by a **put option at par** and a **ratchet**.

**The dollar has a major impact on the valuation**
80% of MTU's revenues are generated in dollars. Some are hedged by purchases and costs in dollars.
Net exposure of around $880m, largely hedged (72% in 2010 (at 1.43), 41% in 2011 (1.42) and 9% in 2012)
**Impact: Δ 1 cent = Δ €4/5m EBIT**

Natixis Securities target price: €48

## LIMITED DEBT AND GOOD FCF GENERATION, SIZEABLE PENSION LIABILITIES

| Financial position (M€) | 31/12/2009 |
|---|---|
| **CB 2,75% 2012** (1) | **148,9** |
| Promissory notes: June 2012 – June 2014 | 65,4 |
| Others liabilities to banks | 14,6 |
| Finance lease liabilities | 25,8 |
| Loan from British Columbia to MTU Maintenance Canada (Nov 2010) | 12,9 |
| Net value of derivative instruments | -4,4 |
| **Cash & equivalents** | **120,8** |
| **Net debt** | **142,4** |

(1) In 2008, MTU repurchased €27.2m of its own CB @ 80.7%

| | 2009 | 2010e | 2011e |
|---|---|---|---|
| Net debt / Equity | 26% | 15% | 5% |
| *(Net debt + Pension) / Equity* | *87%* | *68%* | *50%* |
| Net debt / Ebitda | 48% | 32% | 10% |
| *(Net debt + Pension) / Ebitda* | *159%* | *140%* | *110%* |
| Ebitda / Interests | 15,2x | 15,5x | 16,8x |

**Pension liabilities:**
96% of pension liabilities concern Germany.
The gross pension liabilities amount to €473.3m.

The value of the assets intended to finance the pension liabilities is €26.5m (≈2/3 equities, 1/3 bonds) and the amount of the unrecognised actuarial losses is €37.6m.
After deducting these two items, the amount of the liabilities recognised on the balance sheet stood at €411.6m at 31/12/2009, i.e. 1.5x gross debt.

Average annual cost: €25m.
Sensitivity to the discount rate:
Δ +/-25bp of the rate = Δ -/+ €11m on the value of the liabilities.

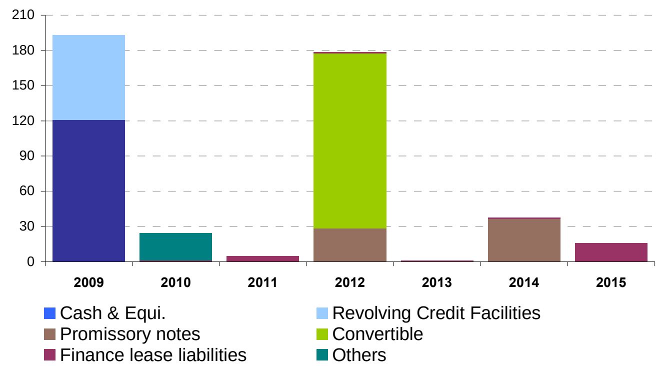
**Bank facilities: Revolving Credit Facility (RCF)**
€100m line, negotiated in August 2009, duration of 3 years.
€27.7m drawn as bank guarantees: €72.3m available.

**Covenants:**
- *Promissory notes*: ND/Ebitda< 2.5x; Ebitda/Interest payments> 4.0x
- *RCF*: ND/Ebitda <2.5x; Ebitda/Interest payments> 4.0x

The covenants were largely complied with at 31/12/2009.

The group also has 3.1m treasury shares (€120m) and €27m in own convertible bonds.

**Debt repayment schedule (€m)**




**Available cash estimates (Natixis Securities)**

| (€M) | 2009 | 2010e | 2011e |
|---|---|---|---|
| Cash flow from operations | 219 | 229 | 252 |
| (-) Capex | -133 | -115 | -120 |
| (-) Var. WCR | 34 | -10 | -3 |
| (-) Dividend | -45 | -45 | -49 |
| | 75 | 58 | 80 |
| Net debt | *180* | *121* | *41* |
| **Cash available to service debt** | **144** | **203** | 283 |

The redemption of the convertible bonds in February 2012 is now ensured according to Natixis Securities' estimates.

R&D and capex outlays are set to remain high in the years ahead, as MTU is looking to take part in new programmes and has to develop its sites.

FCF: used to pay dividends, for SBB and the repayment of financial liabilities.
- Share buybacks: 6.5 million shares between 2006 and 2008, for €213m.
- 3 million shares cancelled in 2008. Still carries 3.1 million shares today (5.9% treasury stock).
- SBB: none since the end of 2008.

**Dividends: CB protection**
In the last few years, the average payout rate was 30% and the yield 3%.

Trigger (protection):
FY 2010: €1.11 Natixis estimate: €0.93
FY 2011: €1.11 Natixis estimate: €1.00

No adjustments expected.

## THE POINT OF VIEW OF THE RATING AGENCIES.

**Moody's: Ba1 / Positive, (September 2009)**
In September 2009, Moody's upgraded its rating outlook to Positive vs. Neutral. This reflected the good control of FCF and progress in debt reduction.
Its credit ratios have been maintained above expectations for its category, with an ND/Ebitda<3.0x and a RCF (Retained Cash Flow) on ND>20% over the last 12 months, supporting the good cash flow generation.
Conditions to move to the Investment Grade category in the medium term (12-18 months):
- RCF/ND> 25%, Ebita margin> 8%, Debt/Ebitda< 3.0x.
- Strong liquidity, with FCF generation supported by a controlled WCR, limited returns to shareholders.
- Stronger diversification of the engine portfolio and a broader MRO client base.

**S&P: BB+ / Stable (June 2009)**
S&P highlights the dollar exposure, the problems of the A400M and the pressure relating to possible order cancellations to justify its rating and the Stable outlook.
In its most recent note, the agency estimated that the potential for a rating upgrade was limited, as a result of its exposure to the civil aviation industry (cyclical and competitive) as a supplier, its modest size and its diversification, which is still too weak.
Recovery rate: 50%-70% for Promissory notes, 30%-50% for the CB (the Promissory notes have a better guarantee structure).

## MTU 2.75% 2012: neutral on the CB

CB Price Simulation

| | |
|---|---|
| **Price** | 108 |
| *Equity* | *43,825* |
| *Credit spread* | *320bp* |
| *Repo* | *75bp* |
| IV | 36.5% |
| Premium | 22% |
| YTM | -1.54% |
| Spread swap | -285bp |
| Delta % | 32% |

| | | Equity 40 | 43,8 | 48 (TP Natixis) |
|---|---|---|---|---|
| VOL | 30,0% | 102,7 | 105,9 | 109,8 |
| VOL | 36,5% | 104,7 | 108,0 | 111,7 |
| CS | 220bp | 106,0 | 109,1 | 112,7 |
| CS | 320bp | 104,7 | 108,0 | 111,7 |
| CS | 420bp | 103,5 | 106,9 | 110,8 |

The upside on the MTU 2.75% 2012 convertible looks limited: if the underlying still offers a certain margin of progression (TP €48 for Natixis Securities), the spread between implied volatility and that of the options is substantial: IV Call ATM 1Yr: 30%, *ie* 650bp below CB's IV.
The credit spread, at 320bp, is in line with the BB+ rating and an IG rating is unlikely for another 12 to 18 months.

Next publication: Q1 2010 results, on 20/04/2010

07 April 2010

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