

BAE SYSTEMS (BA.)
Share price 345.50p

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SUMMARY

A clear difference in valuation between it and major peers (see below) looks somewhat overdone. Risks with BAE are in the pension fund and slowing growth, however both are well documented. Underlying cash flow and asset base look solid. Overall it looks relatively cheap. The company is much more widely spread by both product and geography than of old. It is also heavily US centric which is where most of the decisions are made. This then means risks should be lower than previously.

FINANCIALS**Earnings Analysis**

Good consistent record in the last 5 years with c25% growth in earnings per share and c10% Dividend per share growth. Cynically one might say that the risks of a contract cock-up for a contractor increase after a run of 5 years! However it has a much more diversified spread than of old, so the impact if it occurs would be more modest.

Growth has been driven by acquisitions and favourable currency, however underlying sales and profit growth was 35% and 10% last year. A bigger currency benefit expected in current year (20% on US\$) which implies analysts forecasts don't expect much underlying growth. Expectations are for a further 15% growth this year and 6% in 2010. The lower growth in 2010 does seem to be a differentiator compared to some of the other defence contractors which expect nearer 10%, however anyone like Boeing or EADS (Airbus) with civil exposure has weaker growth.

In 2008 operating margins rose to 10.2% (9.2% prior year) which must be near to peak. The Saudi operations (International Division) always makes the highest margins. Mix change towards more electronics should generally favour margin

growth LT. Tax rising marginally in 09 to 28% (26%)

Sales growth is supported by healthy order book of £46.5bn compared to 2009 estimated sales of £20.6bn.

Valuation

BAE has clear peers internationally. The closest are Lockheed Martin Corporation (11.2x), Boeing (11.2x), Northrop Grumman (9.8x), General Dynamics (9.8x), Raytheon (9.7x) and EADS (9.8x). BAE trades at only 7.7x December 2010 estimates. Slightly lower relative growth and the Pension deficit seem to be the big differentiators. BAE does at least have the support of weak sterling in terms of translation of earnings. Yield is also nearly 5%

Cash flow Analysis

Some excellent free cash generation in recent years. In 2007 BAE generated over £1bn free cash and £0.7bn on 2008. The money has been spent on strategic acquisitions with £1bn spent in 08 and £1.5bn in 07. Further commitments to buy 2nd half of VT Group already this year. In the current year an extra £400m is being set aside for pension funding, but cash flow is still likely to be good. A major impact has been a healthy stream of contract awards (notably 72 Typhoons from Saudi in 2007), which come with large up front advance payments. Continued strong cash flow hence depends on contract flow.

Balance sheet Analysis**Asset Values**

NAV was c£7.2bn with the breakdown broadly: £12.3bn Intangibles (lots of acquisitions in last 5 years), Tangibles £3.4bn, Working capital - £5.0bn (due to large advances of £4.8bn), Pension liability -£3.4bn, Provisions -£1.0bn, Deferred Tax asset £1.0bn., Net debt c£0bn.

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Pension issues and customer advances are both well known. Assets increased £1bn last year due to currency and a greater increase is expected this year. They are committed to pay in £800m into the pension fund this year compared with £400m last year.

The Balance Sheet as usual contains numerous notes about impairments, provisions and potential liabilities. Most significant was Saab stake write down of £120m.

Debt and Liquidity

£39m net cash. Cash position has weakened in recent years due to acquisitive expansion. Company has quite a high gross cash position of £2.3bn and also £1.3bn unused facilities so actually has a lot of headroom and good cash flow to cover potential liabilities.

Net cash fell £370m due to exchange last year. Expect larger effect this year.

THE BUSINESS – Defence Contractor
Business Analysis & Products

Now split into 4 main divisions unlike the old days when it was just Defence and Civil. Service accounts for c15% sales, with the largest customers US Department of Defence (42%), UK Ministry of Defence (22%) and Saudi (9%). Civil now practically all gone and the four businesses are:

- Programmes & Support (24% sales). This is essentially the planes and ships operations. Big contracts are the typhoons (57 + 97 delivered to UK and Europe, now starting export batch), Hawk and Griphen and Type 42 destroyers. Business is stable.
- Land & armaments (34%) very strong in US, but the lowest margin business. Saw excellent growth last year on the back of US MRAV programme. Future depends a lot on level of hostilities in Iraq and Afghanistan.
- Electronic, Intelligence & Support (24%) – seen expansion from acquisition. Very much the focus of investment to anticipate trends in

defence spending. 6% underlying growth last year.

- International (18%) – includes Saudi, Australia, South Africa and Euro operations. The highest margin segment now and historically. Good margins on Saudi support work and about to start delivery of Typhoons. Business is stable.

MARKET POSITION & COMPETITORS

BAE is No.3 globally, No.6 in US (below contractors in valuation comment), No.1 in UK, Saudi and Australia and No.2 in Sweden and S.Africa. They now focus on these six territories and perhaps India. They are always likely to get a large share of global market due to its particular areas of specialisation.

Market Outlook

US defence spend is at an all time high in real terms since World War II at \$672bn. It accounts for 44% of global spend. BAE had 59% of sales here. UK is actually 5% of world spend and is second largest market in the world (BAE has 20% sales here), while Saudi is No.6 with 2%. So it has exposure to most of the big “available markets”. The US market is expected to remain firm despite recession pressures, due to overseas commitments. UK is stagnant at best, though lots of support work ongoing. Australia +3%.

RECENT SHARE PRICE PERFORMANCE

Relative underperformance – short term switch from defensives to cyclical stocks has hurt over the short term

Share price:
 High 408p on 26th Jan 2009
 Low 321p on 15th June 2009

Relative performance:
 (6 months): -9%
 (3 months): -2%

26th June 2009**BAE SYSTEMS (BA.)**
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SECTOR PEERS

Lockheed Martin (NYSE:LMT)
Boeing (NYSE:BA)
Northrop Grumman (NYSE:NOC)
General Dynamics (NYSE:GD)
Raytheon (NYSE:RTN)
EADS (PA:EAD)

CONSENSUS: BUY/OVERWEIGHT

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