Precision Castparts Corp PCP

Analyst Research Analyst Report Archive Top Rated Stocks in Sector

PCC benefits from the strong aerospace cycle in place.

by
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Analyst Note

Narrow-Moat Precision Castparts Posts Fiscal Second-Quarter 2015 EPS
by Neal Dihora, 10/23/2014

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Investment Thesis 07/24/2014

Precision Castparts is one of only a few providers of certain large, highly complex castings used in aircraft jet engines and power turbines that maintain structural integrity under intense thermal conditions. Highly specialized products with tight tolerances result in high switching costs, creating a narrow economic moat around the business. As proof, its largest customer, General Electric, has been buying products for more than four decades. CEO Mark Donegan has been instrumental in a continual push toward efficiency and minimizing waste. Over the years, the company has fine-tuned its manufacturing process, extracted and shared cost savings with customers, and improved operating margins to nearly 28% in fiscal 2014 from 12% in fiscal 2001.

PCC spends around 3% of sales on capital expenditures annually. High operating margins driven by technically specialized products drive returns on invested capital, which lead to strong cash generation that is used to solidify and grow its position in the marketplace through strategic acquisitions. The recent TIMET acquisition is a good example of PCC quickly improving asset utilization and delivering strong returns to shareholders.

PCC benefits from the strong aerospace cycle in place. For example, Boeing has planned aggressive production rate increases for the 737 and 787 platforms, and Airbus has similar expansion plans for the A320 and A350. Combined with a focus on optimal asset utilization, the firm can generate strong incremental margins on the higher volume. The industrial gas turbine business has been in a lull for new builds, but recent commentary from manufacturers points to an improved outlook. Positively for both aerospace and gas turbine segments, the company has stated it has higher dollar content on the next-generation engines, some that are 2-3 times as much, that will help growth even in a flat volume environment. Additionally, it has secured customer wins for oil and gas drilling pipes that bode well for future growth. PCC is in an enviable position in the industry because of lofty customer switching costs and a solid reputation.

Economic Moat 07/24/2014

PCC manufactures highly complex, technically challenging components for aerospace, power, and other industrial markets that adhere to strict tolerances and perform under harsh conditions. Over the years, PCC has fine-tuned its processes to provide these components at low prices to customers, including General Electric, Rolls Royce, and United Technologies. Customers are loath to switch suppliers that meet the rigorous criteria. This high switching cost creates a narrow economic moat around PCC's business. With returns on capital at more than 20%, the company easily earns more than its 9% cost of capital.

Valuation 10/23/2014

We are lowering our fair value estimate for narrow-moat Precision Castparts to $255 per share from $269 after it reported fiscal second-quarter 2015 results. We have reduced our sales growth projections by 150 basis points to mid-7% level to reflect low-single-digit production growth, Precision's content share gains, and the 4% posted organic growth during the last year that saw deliveries grow 7%. There

Morningstar's Take PCP

Analyst

Price 12-15-2014	Fair Value Estimate	Uncertainty
231.29 USD	255 USD	High
Consider Buy	**Consider Sell**	**Economic Moat**
153 USD	395.25 USD	Narrow
Morningstar Credit Rating		**Stewardship Rating**
A		Standard

Bulls Say

- The increase in production rates announced by Boeing and Airbus, combined with new platforms such as the 737 MAX and A320neo, will power sales and profits in the near to medium term.
- The firm will continue to make value-adding acquisitions that improve its product offering or enhance its internal supply of materials. Acquisitions totaled $8.4 billion over the last five years.
- PCC is one of only a few manufacturers in the world that can produce large metal castings to meet the cost and quality demands of its customers.

Bears Say

- PCC has little control over pricing as it serves an oligopolistic jet engine-making customer base, which itself remain pressured by the intensely competitive large aircraft manufacturers Boeing and Airbus. If PCC is unable to offset decreased pricing with cost-cutting measures, margins could suffer.
- The power generation market currently has excess capacity; new turbine demand could be further out than calendar 2014.
- Delays in production rate increases can leave a hole for PCC's products and result in lower incremental margins as its plants are underutilized.

Competitors PCP

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Name	Price	% Chg	TTM Sales $ mil
Precision Castparts Corp	**$231.29**	**0.43**	**9,979**
NSK Ltd	$13.29	—	7,782
NSK Ltd ADR	$23.17	-4.12	7,782
Allegheny Technologies Inc	$30.33	-0.72	4,091
Minebea Co Ltd ADR	$26.76	1.79	3,436
Valmont Industries Inc	$126.59	-1.91	3,188

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are many moving parts to Precision's sales growth, including customer inventory management, but our earlier growth estimates seem too high. Further, lower oil prices and softer worldwide economic growth are negative for planned aircraft production growth rates. Our estimates include high incremental margin performance driven by solid aerospace production rates. For example, Airbus and Boeing have more than 11,500 aircraft yet to be delivered. Further, Boeing has announced plans to raise the monthly production rate of the 787 to 12 per month in 2016 from 10 per month due by year-end 2013. The firm is set to benefit from higher aircraft production and rebounding sales within the power marketplace. Customers cleared inventory during the last year and are better aligned to actual end-market demand, providing Precision with better visibility over the medium term. Our base case assumes mid-7% average revenue growth and 29% average operating margin driven by higher production schedules. Its Airframe products business (formerly fasteners) has quickly rebounded to nearly 30% operating margin, and could reach the 32% levels of fiscal 2010. Still, customers request annual concessions of 2%-3%, and this is included in our estimates. Upside could result from further acquisitions.

Risk 07/24/2014

PCC sells to highly cyclical markets such as aerospace, power generation, and automotive. Its customers demand annual price concessions and promote competition within their supplier base. If PCC is unable to cut costs fast enough to offset these falling prices, margins could suffer.

During the financial crisis, customers' inventory destocking caused revenue and margin pressure at the company. Many of its products are inputs into other interim products, resulting in potentially unmanageable channel-inventory issues. For example, its casting division manufactures parts for aircraft engines. These parts are sent to engine manufacturers such as GE, who will complete the engine. However, GE's customer may have delayed engine acceptance due to decreased demand for new airplanes. This causes GE to build inventory of engine parts, resulting in lower future orders for PCC, at least over the near term. Beyond timing issues, government regulation can hinder approvals for both aircraft and power plants.

Management 05/10/2013

PCC's management has created a fully integrated supply chain by identifying and integrating acquisitions, capturing synergies across the board, and taking out costs quarter after quarter, as evidenced by the company's yearly margin expansion. GE alumnus Mark Donegan, who joined the company in 1985 and became CEO in August 2002, has been driving much of this operational proficiency. Donegan held numerous management positions throughout the company and continues to work beside the company's management at various manufacturing operations. We believe management serves shareholders well. While management has been loath to offer quarterly or even annual financial expectations, it did offer long-term goals for fiscal 2016 during its fiscal third-quarter earnings release in January. We believe the company was providing its take on the opportunity following its increased levels of acquisitions, and we see the increased level of transparency as welcome by the markets.

Overview

Profile:

Precision Castparts makes complex metal components for aerospace, power generation, and other industrial applications. Its investment castings (26% of fiscal 2014 revenue) are essential to jet engine and gas turbine functionality, while its forged products (44%) and fastener systems (30%) are found in such critical areas as aircraft wing structures, seamless pipes, aircraft brakes, and fuselage connections. By end market, aerospace constituted 68% of PCC's sales, power generation was 18%, and other general industrial markets was 14%.