03-May-2017

Spirit AeroSystems Holdings, Inc. (SPR)

Q1 2017 Earnings Call

CORPORATE PARTICIPANTS

Ghassan Awwad
Executive Director of Investor Relations and Corporate Strategy, Spirit AeroSystems Holdings, Inc.

Thomas C. Gentile
President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.

Sanjay Kapoor
Executive Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.

OTHER PARTICIPANTS

Howard A. Rubel
Analyst, Jefferies LLC

George D. Shapiro
Analyst, Shapiro Research LLC

Samuel J. Pearlstein
Analyst, Wells Fargo Securities LLC

Peter J. Arment
Analyst, Robert W. Baird & Co., Inc. (Broker)

Douglas S. Harned
Analyst, Sanford C. Bernstein & Co. LLC

Cai von Rumohr
Analyst, Cowen & Co. LLC

Jason Gursky
Analyst, Citigroup Global Markets, Inc.

Carter Copeland
Analyst, Barclays Capital, Inc.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Seth M. Seifman
Analyst, JPMorgan Securities LLC

Robert M. Spingarn
Analyst, Credit Suisse

David E. Strauss
Analyst, UBS Securities LLC

Richard T. Safran
Analyst, The Buckingham Research Group, Inc.

Michael Ciarmoli
Analyst, SunTrust Robinson Humphrey, Inc.

Hunter K. Keay
Analyst, Wolfe Research LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good morning, ladies and gentlemen and welcome to the Spirit AeroSystems Holdings Incorporated First Quarter 2017 Earnings Conference Call. My name is Ryan, and I'll be your coordinator today. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please also note this event is being recorded.

And now, I would like to turn the presentation over to Mr. Ghassan Awwad, Director of Investor Relations. Please proceed.

Ghassan Awwad

Executive Director of Investor Relations and Corporate Strategy, Spirit AeroSystems Holdings, Inc.

Thank you, Ryan and good morning everyone. Welcome to Spirit's first quarter 2017 earnings call. I'm Ghassan Awwad. And with me today are Spirit's President and Chief Executive Officer, Tom Gentile; and Spirit's Executive Vice President and Chief Financial Officer, Sanjay Kapoor.

After opening comments by Tom and Sanjay regarding our performance and outlook, we will take your questions. In order to allow everyone to participate in the Q&A segment, we ask that you limit yourself to one question, please.

Before we begin, I need to remind you that any projections or goals we may include in our discussions today are likely to involve risks, which are detailed in our earnings release, in our SEC filings, and in the forward-looking statements at the end of this web presentation. In addition, we refer you to our earnings release and presentation for disclosures and reconciliation of non-GAAP measures we use when discussing our results. And as a reminder, you can follow today's broadcast and slide presentation on our website at investor.spiritaero.com.

With that, I would like to turn the call over to our Chief Executive Officer, Tom Gentile.

Thomas C. Gentile

President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.

Thank you, Ghassan, and good morning, everyone. Welcome to Spirit's 2017 first quarter earnings call.

We're off to a good start this year, delivering on our commitments to our customers and executing on multiple production rate changes at the same time. We are on track to ramp-up the production rate on the Boeing 737 program from 42 airplanes per month to 47 per month before the end of the second quarter and increase the A350 production rate to 10 per month by 2018. We delivered a record 410 shipsets compared to 397 shipsets in the same period last year.

We also celebrated several milestones along the way. We are very proud to contribute to the successful first flights, the 787-10 and the 737 MAX 9 earlier this year. Spirit plays a major role in the design and build of both of these state-of-the-art airplanes, and we'd like to congratulate our largest customer, Boeing, on achieving this monumental milestones.

On the defense side, we're looking forward to starting the next phase of the CH-53K helicopter program, now that the defense acquisition board has approved Milestone C, authorizing LockHeed Martin Sikorsky and Spirit as a major supplier to enter production of this highly capable heavy lift helicopter. We are honored to play a crucial role in the development and production on the composite forward fuselage to the CH-53K.

With regard to capital deployment, in the first quarter we executed on our current share repurchase authorization of up to $600 million by deploying $81.5 million for the repurchase of 1.4 million shares. Also after paying our first quarterly dividend of $12 million in January, our Board of Directors declared another quarterly dividend of $0.10 per share.

We have up to $518 million remaining in our authorized share repurchase program. We intend to gradually grow our dividend overtime. And our capital allocation strategy remains one of maximizing total shareholder return.

Relative to the A350 program, we delivered a record 24 shipsets in the first quarter of to Airbus. Our team in Kinston, North Carolina continued its extraordinary efforts to recover from the aftermath of Hurricane Matthew that disrupted our operations for several weeks in October of 2016. This disruption resulted in eliminating the production buffer that we had, and caused us to expedite deliveries using air shipments in order to remain on-schedule for our customer. Meeting our quality and delivery commitment to Airbus is of utmost importance to us, while we recover schedule and ramp up production rates simultaneously to 10 units per month by 2018.

As I mentioned on last quarter's call, we have filed appropriate claims with our insurers. We incurred abnormal operating expenses in Q4 2016 of $12.1 million, and now the additional expenses incurred in Q1 2017 of $10.8 million, which we're able to offset and deliver on our financial commitments. We do expect some residual expenses to be incurred during 2Q 2017 on our path to full recovery.

On the top with the Boeing negotiations, while discussions have been constructive, they are taking longer than expected. The gap remains significant. My sense is that both parties desire to close the open issues, and as we've said many times, we're seeking a fair and equitable agreement. We will continue to be a trusted partner and deliver on our commitments to Boeing. If we are not able to reach commercial agreement on the open issues, then we will consider taking appropriate steps to remediate those issues as outlined in the current contracts. Irrespective, we remain committed to our 2017 guidance and our long-term goal of converting 6% to 8% of revenue to free cash flow.

Turning to some key focus areas in 2017. Executing our multi-year supply chain strategy remains a top priority for Spirit to maintain our competitiveness. We have a very good plan and we are on track in our day-to-day execution of that plan. Today, we have completed clean sheets for more than 50,000 part numbers in order to establish "should cost" for each of those individual parts. And we are actively engaged with our suppliers on more than 10,000 of those parts to help them achieve those "should costs". We operate in a very competitive marketplace and our customers expect us to achieve "should cost" as well.

In addition, we've started expanding our fabrication business and initiating work packages in order to leverage our internal capabilities, open capacity and cost structure. In line with this new strategy, we recently made major investments in our McAlester, Oklahoma facility and added three-axis and four-axis machines to establish a machining center-of-excellence at that site.

Growth is a key pillar of our strategy. We continue to explore and evaluate opportunities to grow our top-line, both organically and inorganically. We see some bolt-on opportunities in the supply base and we may explore some larger transactions given the capacity that we have under our current debt structure.

We will be disciplined and rigorous in evaluating any significant transactions. Any potential opportunity must meet a very high threshold for us to move forward. It must fit strategically and provide a growth engine. It must also be accretive and increase our capabilities.

Now let's take a look at Q1 results. For the quarter, we reported revenue of $1.7 billion. Operating income was $214 million and net income was $142 million. Reported earnings per share were $1.17. Operating cash flow was a $112 million and pre free cash flow was $71 million. Our backlog at the end of the first quarter was $46 million with work packages and all the commercial platforms in the Boeing and Airbus backlog.

Now turning to 2017 guidance. That guidance remains unchanged. We expect 2017 sales to be between $6.8 billion and $6.9 billion. And earnings per share of between $4.60 and $4.85. Free cash flow is expected to be between $450 million and $500 million or about 7% of revenue.

With that, I'll ask Sanjay to provide you with some more details on the financials and give you more specifics about the first quarter. Sanjay?

Sanjay Kapoor

Executive Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.

Thanks, Tom, and good morning, everyone. Let me summarize our first quarter financial results and full year 2017 outlook, then we will take your questions.

So starting on slide 3. Revenue for the quarter was $1.7 billion, up 1% compared with the same period of 2016. We met our customers' requirements relative to delivery rates and delivered a record 410 shipsets. The increase was primarily driven by a higher production delivery on the Airbus A350 program, offset by lower production deliveries on the Boeing 777 program.

For the quarter, we delivered a 126 737s, 21 777s, 32 787s, as well as 154 A320s, and a record 24 A350 shipsets. We're in the midst of executing on multiple production rate increases. Most notably, on the Boeing 737 program from rate 42 per month to rate 47 per month before the end of the second quarter this year. As well as the ramp-up to rate 10 a month on the Airbus A350 program by 2018. Our backlog at the end of the first quarter was $46 billion, which provides us a stable planning horizon for our business.

Moving to slide 4. First quarter reported earnings per share were $1.17 compared to $1.29 in the first quarter of 2016. The $1.17 in the quarter included a net benefit of $0.03 per share from changes in estimates, whereas $1.29 in 1Q 2016 included a net benefit of $0.22 per share from changes in estimates primarily due to the recognition of overhead and supply chain initiatives. Profitability in the quarter was impacted by lower deliveries on 737 by four shipsets. Lower deliveries on the 777 by five shipsets. As well as costs related to the severe weather event in Kinston.

Earnings per share in the quarter benefited from lower average share count, down 9% year-over-year. After considering the net impact of these headwinds and tailwinds, we continue to see operational improvement in our earnings year-over-year.

Turning to free cash flow on slide 5. Free cash flow for the quarter was $71 million, compared to $43 million of free cash flow in the same period last year. 1Q 2016 free cash flow was reduced by $43 million due to the final cash payment received under the Boeing 787 interim pricing agreement. Excluding these payments, which were never included in our free cash flow guidance, we see significant improvement in this key metric year-over-year.

Capital expenditures for the quarter were $41 million compared to $51 million in the same period last year. I want to remind you that CapEx is lumpy in nature, and we still expect CapEx to remain steady in the range of $250 million to $300 million for this year. Converting revenue to free cash flow at a rate of 6% to 8% consistently remains the key focus of us and the number one measure of the financial health of our business.

Turning next to capital deployment on slide 6. In the first quarter, we repurchased 1.4 million shares for $81.5 million under the current share repurchase authorization of up to $600 million. In addition, our Board of Directors declared another quarterly cash dividend of $0.10 per share. As Tom mentioned in his prepared remarks, we remain steadfast on maximizing total shareholder return through a balanced and disciplined approach to capital deployment.

For our Fuselage segment results, let's turn to slide 7. Fuselage segment revenue in the quarter was $917 million, up 5% from $876 million in the same period last year, primarily due to higher production deliveries on the Airbus A350 program and increased defense related activity, partially offset by lower production delivery on the Boeing 737 and 777 programs.

Operating margin for the quarter was 16.4% as compared to 20.3% in the same period last year, primarily due to increased revenue from lower margin programs and lower production deliveries on the Boeing 737 and 777 programs. On a normalized basis, after reversing the changes in estimate charges recognized during 1Q 2017, Fuselage segment margin was 17.1%.

On the A350 program, we delivered 24 shipsets in the quarter, which was a record compared to the 14 shipsets in the same period last year. As we continue to ramp up production rate, we're focused on meeting our commitments to our customers and ensuring on-time deliveries using all means necessary, including air-shipping our products. During the quarter, we took a small charge related to a temporary failure of a critical piece of equipment in Kinston causing further disruption to the overall schedule. We are making investments in this area to improve our tools and processes in order to minimize the likelihood of future disruption and accelerate our recovery efforts.

Deferred production balance decreased by $3.4 million on the A350 program despite a favorable cum catch-up adjustment and unfavorable foreign exchange impact.

Now turning to slide 8 for our Propulsion segment results. Propulsion segment revenue in the quarter was $406 million, down from $439 million in the same period last year, primarily driven by lower production deliveries on the Boeing 777 program.

Operating margin for the quarter was 18.1% as compared to 22.6% in the same period last year, primarily driven by favorable changes and estimates that were recognized in the first quarter of 2016. In 1Q 2017 operating margin was impacted by lower margin recognized on Boeing programs, mainly the 777 program, as well as the dilution effect of the aftermarket business change. On a normalized basis after reversing the changes in estimate charges during 1Q 2017, Propulsion segment margin was 17.8%.

For our Wing segment results, let's turn to slide 9. Wing segment revenue in the quarter was $369 million, up 2% from $361 million in the same period last year in part due to higher production deliveries on the A350 program. In addition, we have some small comparable and offsetting changes in revenue on the Boeing 787 program between the Wing and the Propulsion segments.

These increases to revenue were partially offset by lower production deliveries on the Boeing 747 and 777 programs, as well as the impact from foreign currency fluctuations on the Airbus A320 program.

Operating margin for the quarter was 15.9% as compared to 16.3% in the same period last year. On a normalized basis, after reversing the changes and estimate charges recognized during Q1, 2017, Wing segment margin was 13.2%, compared to 12.7% in the prior year.

Now turning to 2017 guidance on slide 10. We are reaffirming our guidance for 2017 for revenue to be between $6.8 billion and $6.9 billion. Earnings per share to be between $4.60 to $4.85, and free cash flow to be between $450 million to $500 million, or 7% of revenue. And our guidance is based on an effective tax rate of 31% to 32%.

So now, let me hand it back over to Tom for some closing comments before we take your questions.

Thomas C. Gentile

President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.

Thanks, Sanjay. In short, it was a strong quarter for operations. Deliveries were up, and we are ramping up production rates on schedule. We continue to seek a commercial resolution on the open issues with Boeing. We're executing on our growth strategies, including the increase in our fabrication business.

We met our financial commitments for the quarter, repurchased $82 million of our stock, have up to $518 million remaining in our share repurchase authorization program, and began paying quarterly cash dividends of $12 million. We remain committed to our 2017 guidance, and our long-term goal of converting 6% to 8% of revenue to free cash flow.

So with that, we'll be happy to take your questions.

QUESTION AND ANSWER SECTION

Operator: And we will now begin the question-and-answer session. [Operator Instructions] And our first question comes from Howard Rubel with Jefferies. Please go ahead.

Howard A. Rubel
Analyst, Jefferies LLC

Q

Thank you very much. Terrific numbers on the A350. Can you provide us with a little bit more color and context as to how you're making progress coming down the curve, Tom?

Thomas C. Gentile
President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.

A

Right. Well, Howard, first of all, good morning.

Howard A. Rubel
Analyst, Jefferies LLC

Q

Thank you.

Thomas C. Gentile
President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.

A

We are really on track with the A350 program. So after the global settlement last year with Airbus, we outlined a program related to the deferred inventory and we're on track with that. We originally had about $750 million or so -- $700 million or so of deferred. And the forward losses totaled about $250 million, so the plan was to recover about $450 million in cash through the 800 units that we have in the current block. And we're on track with that.

This year – this quarter as you saw the deferred came down about $3.4 million and that was in spite of a favorable cum catch as well as some unfavorable trends on foreign exchange. And we expect that we will stay on that plan to collect the $450 million through the program.

Howard A. Rubel
Analyst, Jefferies LLC

Q

Thanks very much.

Operator: The next question today comes from George Shapiro with Shapiro Research. Please go ahead.

George D. Shapiro
Analyst, Shapiro Research LLC

Q

Yeah. Tom, on the Boeing contract, it seems to me like you made a comment about being kind of far apart, which is different than what you've made in the past. So, number one, what's changed? And number two, you're still comfortable with the interim agreement? Thanks.

Thomas C. Gentile
President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.

A

Right. Well, as I said, we've been involved in discussions and they've been constructive. We shared a lot of data back and forth, engineering data and cost data, and we've had our engineers involved and their engineers and we've been engaging at the most senior levels of both organizations. So that's been good. But the fact is, is that there is still a gap between us, really on the 737 side as well as the 787 side. We're working very hard to close those, but there is still a gap. And so I just wanted to highlight that so that it was clear.

In terms of where we are with the interim pricing agreement, those are satisfactory for now. It would be better to get to a final commercial settlement and remove some of the uncertainty that surrounded it. But if we didn't, we have the interim arrangements in place and we feel those are satisfactory. We can reaffirm our guidance for 2017 with those and we also remain committed to long-term to the 6% to 8% conversion for revenue to cash flow.

George D. Shapiro
Analyst, Shapiro Research LLC

Q

Okay. Thanks.

Operator: Our next question comes from Sam Pearlstein with Wells Fargo. Please go ahead.

Samuel J. Pearlstein
Analyst, Wells Fargo Securities LLC

Q

Good morning.

Thomas C. Gentile
President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.

A

Good morning, Sam.

Samuel J. Pearlstein
Analyst, Wells Fargo Securities LLC

Q

Tom, actually just following up on some of the last comment you just made about the 6% to 8% free cash flow conversion from revenues. You changed the incentives in the proxy a little bit on the annual incentives, but long-term seems like you are focusing more on that conversion. I guess, what is the behavior you're looking to create? Do you see an ability to drive that higher than that 6% to 8%, because you're already there? So, I'm just to trying to understand what you're trying to drive through with that.

Thomas C. Gentile
President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.

A

Right. Well, the 6% to 8% is a fairly wideband. But it's where we wanted to get to. And you're right, last year we were able to convert at the low-end of the band. This year, our guidance is at the midpoint of the band. But we want to be able to demonstrate that we can do that consistently, Sam, that we are able to deliver. And certainly the Boeing negotiations are one part of that, but really it's more about execution on our overall strategy.

We've got a lot of cost reduction initiatives, specifically with regard to our supply chain. Those are on track. We're executing on those. And we're also investing in growth. I mean, one of the real strong objections that we have is to grow the top line. And so both organically and even inorganically we're looking at those opportunities which would – which should increase the total cash flow. So, first priority is to be consistent in delivering on that 6% to 8% and making sure we're executing on all aspects of our program so that we can do that.

Samuel J. Pearlstein
Analyst, Wells Fargo Securities LLC

Q

Thank you.

Operator: Next question comes from Peter Arment with Robert W. Baird. Please go ahead.

Peter J. Arment
Analyst, Robert W. Baird & Co., Inc. (Broker)

Q

Yes. Good morning, Tom and Sanjay.

Sanjay Kapoor
Executive Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.

A

Good morning.

Peter J. Arment
Analyst, Robert W. Baird & Co., Inc. (Broker)

Q

A quick, Tom, or maybe this is just for Sanjay, just on the kind of the progression that you're talking about with the shipsets. So you're expecting, I guess, in terms of [ph] maybe (23:14) talking about the margin hit here, is that you're feeling the full effects for the 777 this year but you really only – when do we start to see, is it only the second half of the year that you're going to see the benefits on the 737 ramp?

Sanjay Kapoor
Executive Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.

A

Yeah. Peter, that's right. I mean, the 737 ramp up like I said in the prepared remarks as well in the second half of the year, get up to the rates – the higher rates, so we'll start seeing the benefit then. Whereas, the 777, the impact was a little earlier, just when Boeing goes down, so you can backup from there in terms of when our deliveries come down a little bit. So that's the offset that we talked about even at the last call. And that's what we've baked into our guidance. So you'll see the benefit on [ph] 737 (23:52) later in the year, we are seeing a little bit of the impact on the 777 margins right now. But overall, we still feel confident about our guidance for the year.

Peter J. Arment
Analyst, Robert W. Baird & Co., Inc. (Broker)

Q

Okay. Thanks.

Operator: Our next question comes from Doug Harned with Berstein Research. Please go ahead.

Douglas S. Harned
Analyst, Sanford C. Bernstein & Co. LLC

Q

Yes. Good morning.

Thomas C. Gentile
President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.

A

Good morning, Doug.

Douglas S. Harned
Analyst, Sanford C. Bernstein & Co. LLC

Q

When you – when you look ahead at the transitions that you're going through right now, basically the transition to the MAX, the transition to the 777X, how should we think about those in terms of what they do to your margin outlook and what investments you may have to make there?

Thomas C. Gentile
President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.

A

Well, first of all, they're on track and we're all down the line in terms of getting ready for both aircraft and specifically the MAX, we delivered several last year and we're on track to deliver more this year. There's still some open issues with Boeing in terms of the exact Delta price for the MAX. But we are actively discussing what those will be. So in the short term, there could be some pressure, but long term we feel very confident that the plans are in place to deliver on those and we're making the required investments.

777X is a little bit earlier in its cycle, but we're also on track for that and the delivery schedule that Boeing has outlined. They've pushed it back a little bit and so we're keeping close track of that. But I would say, in general, we're on track with both of those.

From the standpoint of margin, we expect that we'll be able to maintain our margin as we make the transition to those two programs.

Douglas S. Harned
Analyst, Sanford C. Bernstein & Co. LLC

Q

And there is one other transition, which is the A350 900 to the 1,000. Is that something that you expect would have much impact on you?

Thomas C. Gentile
President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.

A

No. The changes for that are relatively minor and are completely under control. So we don't expect really any significant impact from that transition.

Douglas S. Harned
Analyst, Sanford C. Bernstein & Co. LLC

Q

Okay. Great. Thank you.

Thomas C. Gentile
President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.

A

Thanks.

Operator: The next question today comes from Cai von Rumohr with Cowen. Please go ahead.

Cai von Rumohr
Analyst, Cowen & Co. LLC

Q

Yes. Thank you very much. So I guess you and Boeing are going to court over the $140 million pension item and you didn't return the $235 million that they'd given you in advances and now you are talking about a gap on the

737 and the 787. And Sanjay, I believe you said if you couldn't resolve it, you would kind of move forward as specified in the contract. Can you be a little bit clear, I mean, you've been at this with them for a while, in terms of how do you guys move ahead so – what's your strategy for getting this done?

Thomas C. Gentile
President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.

A

Cai, let me take that for a second. First of all on the pension, that's an issue that goes all the way back to the separation in 2005. It's a very old issue, the positions are well-established, at some point we just agree to disagree and the best resolution was to seek legal remedies. And so that's where we are. And we'll abide by whatever the court rules on that. But that is really very separate from any of the operational impacts. You also mentioned the $235 million which would have been in advance. We've never counted that in our cash flow and it's really part of the overall discussions on the 787 pricing for the 787-9 and 787-10. And once we resolve those, our expectation is that we would return those funds. And so that's the position there.

On the other issues, as I mentioned, there are still some gaps in terms of where we are, and that's what we're seeking to close, both in terms of the 737 and the Delta pricing for the MAX, and on the 787, it's really the 787-9 and the 787-10 where we have the open issues.

Now in the meantime, we're going to be a trusted partner. We're going to be delivering in terms of cost, quality and timing. And so that's very important is that we establish that. To the extent that we can't agree on the commercial issues, there are mechanisms in the contracts which are all public and we will be following those to get to final resolution.

Operator: And our next question will be coming from Jason Gursky with Citigroup. Please go ahead.

Jason Gursky
Analyst, Citigroup Global Markets, Inc.

Q

Yeah. Thank you, and good morning, everyone. Hey Tom, just a quick question on this Boeing negotiation, maybe coming at it from a different angle or a different way. You suggested that you're far apart. If you were to take Boeing's kind of offer that's on the table now, will we need to see downward revisions to the margins that you've been booking today, it's in a big cum catch-up? And are there some things that you can do on the supply chain side to help mitigate some of these issues? I know you've been working on [indiscernible] (29:02) types of things over time. Just kind of what are you doing on your end to help drive your ability to get closer to where Boeing is? Thanks.

Thomas C. Gentile
President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.

A

Right. Well, as we've said, we're going to seek a fair and equitable agreement, and that's what our focus is in the discussions, number one. Second is the interim arrangements are satisfactory, and are in line with our guidance for 2017. And also that we remain committed to the 6% to 8% goal of converting revenue to free cash flow. So those are where we are.

Now, as I said, our ability to deliver on that long-term aspiration counts on execution and on a number of factors, so it's not just the Boeing negotiations, you mentioned some supply chain and that's absolutely critical for us. Two-thirds of our cost is in supply chain and we have been working very hard with our suppliers to become more competitive. I mean we're a global company, we serve global customers. We have a global supply chain and we need globally competitive rates. So we've been looking at all aspects of that supply chain in order to get the most competitive global rates.

One thing that we mentioned on these clean sheets, which is where we look at each part and the detailed cost of those parts to come up with what the "should cost" is, and we've spent millions of dollars over the last couple of years, we've done over 50,000 of those clean sheets and we're working very actively with our suppliers in order to help them get to the clean sheets. So it's not just about saying here's what we need and please deliver it, we work very actively with them.

So for example on material purchasing, because we're larger than most of our suppliers, we can leverage our scale to help them get better material costs, just like Airbus and Boeing do with us. We're looking at things like helping them buy mill direct on their plates. And we can buy those mill-direct and we can cut them and supply them to some of our smaller suppliers so they get better rates.

We're looking at things like logistics and consolidated logistics for suppliers that are in certain areas so that we can get better rates on that. We're also leveraging our internal processing capability for some of the metallic parts so that the suppliers can get better rates on that. So it's about not only identifying what the clean sheets are, but working with the suppliers to help them achieve that. And those activities are well down the road. We're seeing very good results from them and that's a big part of meeting our long-term objectives of 6% to 8% cash flow conversion.

Operator: And our next question comes from Carter Copeland with Barclays. Please go ahead.

Carter Copeland
Analyst, Barclays Capital, Inc.
Q

Hey, guys. good morning.

Thomas C. Gentile
President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.
A

Good morning, Carter.

Carter Copeland
Analyst, Barclays Capital, Inc.
Q

I will just do two very quick ones. One, can you clarify or just give us some color on what the difference in work scope may be for the 737 MAX versus the 737NG, just to help us get a sense of what kind of scale we're talking about there. And then just a clarification on the expedited shipping on the A350. Is that still going on or is that complete? Thank you.

Thomas C. Gentile
President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.
A

Right. So first of all, on the 737, the difference is on the MAX. We've talked about it a little bit in the past. There were some changes to MAX that are – to increase the loads because there are some heavier weights. And so some of the parts are bigger. On the MAX, there are some new parts that weren't on the 737. And then there were some changes in material and some of the parts and in design, parts that were on the 737NG to the MAX. So there was three or four types of differences that make up those changes in the cost. And that's something that we've gone through in excruciating detail with Boeing is laying out from an engineering perspective and sourcing perspective and material perspective is what the differences were on the Fuselage, on the Wings and in

Propulsion. And a lot of the changes were in the Propulsion, because the new engine, the LEAP-1B engine is much bigger in diameter than the previous engine with CFM56-7B.

And so that's been a big driver of the changes. So that's how we've been addressing that. With regard to the A350, there's still will be some expedited air shipments in Q2 We expect that will catch up during the course of Q2, but there will be some additional ones and we've – we highlighted that in the prepared remarks and we will be working to offset those, as well as to submit those as part of our insurance claim.

Sanjay Kapoor
Executive Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.
A

Carter, just to add, like Tom said, I mean on the 737 MAX, most of the changes are in the Propulsion segment, there's obviously a small change in the Fuselage and on the Wing, but our scope and content remains the same. It's just things are heavier and bigger, and so therefore the value is higher.

Carter Copeland
Analyst, Barclays Capital, Inc.
Q

Great. Thank you, gentlemen.

Operator: Our next question comes from Rajeev Lalwani with Morgan Stanley. Please go ahead.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC
Q

Hi. Good morning. Thanks for the time.

Sanjay Kapoor
Executive Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.
A

Good morning, Rajeev.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC
Q

Tom, maybe even Sanjay, question for you. To the extent that you go down the route of making some sort of legal filing to resolve negotiations with Boeing, how long would something like that take? How disruptive would it be? And then sort of a related question. Tom, when you joined about a year or so ago, what was your expectation around the timeline around resolving some of these issues, and are you now moving past it?

Thomas C. Gentile
President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.
A

Well, first of all, Rajeev, they're complex issues, so these things always take some time. So I didn't necessarily have any preconceived notions. And look, these are active negotiations, so we don't want to negotiate it in public. There – we're having very good dialogues at senior levels, and so we just assume – leave it at that. But what I would say is that regardless-- you mentioned disruption. If these things do escalate in different ways, our focus is going to remain operationally to make sure we continue to deliver on cost, quality and time. And so that isn't going to change. We are going to be a trusted partner for Boeing and we're going to continue to deliver no matter what, it's very important to us.

We are Boeing's biggest supplier, they are our biggest customer by far, obviously. And their success is our success. So we want to make sure Boeing is successful and we're going to continue to deliver. We're not going to let these negotiations, which have been going out for a long time, we're not going to let those negotiations disrupt what's really important, which is delivery.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC
Q

Okay. I'll leave it there. Thank you.

Thomas C. Gentile
President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.
A

Thanks.

Operator: Next question today comes from Seth Seifman with JPMorgan. Please go ahead.

Seth M. Seifman
Analyst, JPMorgan Securities LLC
Q

Thanks very much and good morning.

Sanjay Kapoor
Executive Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.
A

Good morning, Seth.

Seth M. Seifman
Analyst, JPMorgan Securities LLC
Q

Sanjay, you mentioned lower margin on the 777, I guess, that makes sense because the volume is down. But I think I recall in your original pricing agreement there were some volume based pricing,. Is that the case and if so, is it in effect under the interim agreement so that you saw some price offset to make up for the decline in volume and how does that play out on the 737 later in the year?

Sanjay Kapoor
Executive Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.
A

All right. Well, Seth, I am not going to get into the specifics of the contract outside of what was in the public domain, in terms of quantity based discounts, pluses or minuses, et cetera. What I was referring to in our remarks, and I think you should – and I think, like you pointed out, the 777 volume is down and therefore the margins are down. And that obviously impacts the EPS. And of course as volumes come down, there is an impact in terms of fixed cost absorption, so the margin percentages can also be impacted.

Now that's something that's been pretty clear for all of us. That's something that we baked in into our guidance, I think there was an earlier question even today about when does the 737 start to offset the 777 impact that'll start to happen in the latter half of this year. So, the 777 quantities and deliveries are going to continue to come down, that's going to have an impact. But we've got that baked in and we're working really hard to make sure that our costs stay in line with that as well so that we minimize the impact of that, so that it's merely just a fixed cost absorption impact that we will see.

And that's really what – I won't read anything more or less into our numbers, other than what I just said.

Seth M. Seifman
Analyst, JPMorgan Securities LLC

Q

Okay. Thank you.

Operator: And our next question comes from Rob Spingarn with Credit Suisse. Please go ahead.

Robert M. Spingarn
Analyst, Credit Suisse

Q

Good morning.

Sanjay Kapoor
Executive Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.

A

Good morning.

Robert M. Spingarn
Analyst, Credit Suisse

Q

Sanjay, well I've got you here. Your guidance you have a $0.25 swing in the range on the EPS and then the $50 million on the free cash flow. Could you talk a little bit about the major swing factors in there and then, just for a clarification, if you haven't said it before, what's the content on the CH-53K?

Sanjay Kapoor
Executive Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.

A

All right. So, the last question first. I mean the content on the CH-53K is fairly significant. It's the [ph] Fuselage and (38:21) we saw the presentation. You see a picture of that. That's everything that we...

Robert M. Spingarn
Analyst, Credit Suisse

Q

The dollar value -

Sanjay Kapoor
Executive Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.

A

That's everything that we do...

Robert M. Spingarn
Analyst, Credit Suisse

Q

The dollar value of the content?

Sanjay Kapoor
Executive Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.

A

I don't think we've quantified the dollar value, Robert. I don't want to give you a number. Again, you got to remember these are in LRIP right now and these can over the long-term change quite a bit, et cetera. So, it's significant. That's probably where I can leave that. I don't think I can give a dollar values. Now, and going back to your other question, more importantly, in terms of the book end of the guide and we've always given you a guide that's in those kinds of ranges typically and then we've seen this over the last three years. We obviously set our internal plans that are to do much better, as we execute in this -- in the year, we find help get to the better end of our guidance. That's always going to be our plan. That depends on execution, that depends on having no hiccups. We've had a couple of hiccups, whether it be a machine going down or some weather related activity happen. We've absorbed that. Having said that, we've got all kinds of initiatives like Tom mentioned in terms of supply chain and so on, and in terms of our own productivity.

And as we get confident and as we execute on that, and as the rates stabilize both on the downside on the 777, and on the upside on the 737, we expect to do quite well for the year, and that's one of the reasons why we reiterated our commitment on our guidance. And consistent with prior years, we will look at Q2 and Q3 and update our guidance accordingly. So I feel pretty good about it.

Robert M. Spingarn
Analyst, Credit Suisse
Q

It's not driven by the Boeing outcome, the negotiation outcome?

Sanjay Kapoor
Executive Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.
A

No. Again, I know there were a lot of questions on this, and Tom and I really can't negotiate in public, guys. So we got to sort of – we've said as much as we can. I will tell you that the basis of our guidance is our interim arrangements which frankly provide a very good basis for the assumptions, and that's what's baked into our guidance. So the negotiations are based on the foundation of getting a fair and equitable deal that's based on the foundation of discussing based on facts and data and changes. And that's one of the reasons we spend a lot of time going through – it's just very similar to what we did with Airbus, which is look at specifics, look at "should cost", look at material changes and so on and so forth.

So, we're negotiating based on good faith and fair and equitable terms. The guidance has the interim, and the interim is a very sound basis. So, I don't see anything – I don't see a downside there for this year.

Robert M. Spingarn
Analyst, Credit Suisse
Q

But if it's fact-based negotiating, why is it taking this long?

Thomas C. Gentile
President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.
A

What I'll say on that is it's just complex. There are thousands of parts and each part has a slightly different story. And these are big dollar numbers that we're talking about. So, the parties are being very deliberate on both sides to make sure we get it right. Good business takes time.

Robert M. Spingarn
Analyst, Credit Suisse
Q

Okay. Thank you.

Thomas C. Gentile
President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.
A

And the other thing I would say is, we don't want to rush and get to a deal that isn't fair and equitable as Sanjay said. So, we're perfectly happy, given the interim arrangements, to be deliberate and to make sure we get to the right outcome.

Operator: We have our next question from David Strauss with UBS. Please go ahead.

David E. Strauss
Analyst, UBS Securities LLC

Q

Thanks. Good morning.

Sanjay Kapoor
Executive Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.

A

Good morning, David.

David E. Strauss
Analyst, UBS Securities LLC

Q

Tom, so to the follow-up on that [technical difficulty] (41:45) deliver. But there definitely was a change in the tone where you stated, if you can't reach an agreement, you would take action available under your – under the contract. But at the same time, it doesn't sound like that would include stopping or slowing deliveries or anything like that. So, could you just kind of outline to us what actions are available to you under the contract to kind of force this thing to a conclusion?

Thomas C. Gentile
President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.

A

Right. Well, the contracts are largely public, and there are typical types of dispute resolution clauses in those contracts, and that's the path that we would pursue.

David E. Strauss
Analyst, UBS Securities LLC

Q

Okay. As a follow-up, you talked about the gap on the 737 and the 787, but you didn't mention 777. So, as it relates to the transition from 777 to 777X, can you talk about shipset content there, how it could compare? And also as Boeing transitions over and they're shipped – they're [indiscernible] (42:58) they go through this period of blanks, will you actually get paid at a five a month rate or will you be paid at a three and a half month rate? Thanks.

Thomas C. Gentile
President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.

A

Right. Well, the content for the 777X is very similar to the 777, it's just bigger, again, because the GE9X engine is much bigger than the GE9115B, just the diameter of the fan is much bigger. So, you've got a lot more content on the [ph] missile (43:24) and then with the thrust reverser. So – but those discussions are a little bit further out. We're making great progress jointly in terms of the development, but we really haven't even started the detailed discussions on the commercial aspects of it. So I would say that's out there. It's not really involved in the current set of discussions, which are really more focused on the 737 MAX and the 787-9 and 787-10.

With regard to the blanks, the answer is yes, we do get paid. So even if Boeing is delivering at a rate of 3.5, they're going to continue producing at a rate of five for the test articles through 777X and we do get paid for those, yes.

David E. Strauss
Analyst, UBS Securities LLC

Q

Thank you.

Operator: Next question today comes from Richard Safran with Buckingham Research. Please go ahead.

Richard T. Safran
Analyst, The Buckingham Research Group, Inc.

Q

Hi. Good morning, everybody.

Sanjay Kapoor
Executive Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.

A

Good morning.

Richard T. Safran
Analyst, The Buckingham Research Group, Inc.

Q

I had a question on this new mid-sized airplanes. You've expressed a desire to be on that program, Boeing has been talking more about it. And I wanted to know, first, if what you've been talking about today, these negotiations with Boeing, might impact your participation and how you might be thinking about the NMA. If you could, are you already starting to make technology investments here? And if possible, do you think that Boeing is going to be looking for partners here like they did on the 787 rather than just suppliers?

Thomas C. Gentile
President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.

A

Well, we are obviously watching and reading about the middle of market aircrafts like everybody else. As any new program, we would be interested in participating. But Boeing has clearly said that they are looking to do more in-house like they did on the 777X wing. So, we'll see.

Now, aligned with that though is we are making continued investments in our research and development in fuselage, in propulsion and in wing to develop the next generation ideas for those types of structures. And we'll continue making those investments and we'll be presenting those to Boeing and to Airbus for their new models and looking for ways that we can work together.

We think we can bring a lot of value. And so we'll be demonstrating that and continue to make the investments in R&D so that we are developing the structures that will be very useful on the next generation of aircraft.

Richard T. Safran
Analyst, The Buckingham Research Group, Inc.

Q

Well, thanks very much for that.

Thomas C. Gentile
President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.

A

Thanks.

Operator: Next question today comes from Myles Walton with Deutsche Bank. Please go ahead.

Q

Good morning. This is actually [indiscernible] (45:55) for Myles. So with programs like the 787 maturing and the 777 on its way down, are you guys lowering you safety stock on that and driving a little bit of destocking in the supply chain? And then, I know you mentioned A350, you used up your safety stock there. So, is that something you're going to plan to rebuild or are you just sort of comfortable where you're at?

Thomas C. Gentile
President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.

A

Right. Well, in terms of our supply chain, if we're looking at – the 737 is clearly going up in rate. And so we set our safety stocks with our supply chain appropriately. And the programs that are going down in rate like 777 is going down in rate this year from seven to five and 747 went down to a half a month. Again, we set the safety stocks with our supply chain appropriately. And they will change based on volume.

With regard to the A350, the answer is yes, we will rebuild that buffer stock. Part of the focus is the more buffer stock we have, the longer we have between the delivery cycles and the more able we're to ship by sea. So when the buffer stock is lower than the time it takes the ship by sea, that's when we have to revert to air shipments. So, we will absolutely look to rebuild that stock and ship by sea and that will bring the cost down so that we won't incur these extraordinary expenses. But again, with Airbus, the commitment from the beginning, as it is with Boeing, is to make sure we stay on track for deliveries. And if that meant shipping by air, then that's what we went and did.

Q

Great. Thank you.

Operator: Next question comes from Michael Ciarmoli with SunTrust. Please go ahead.

Michael Ciarmoli
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Hey. Good morning, guys. Not to beat this one, but maybe Tom, just on the agreement here with Boeing, how much longer can this interim agreement last? Do you guys think it's satisfactory to meet your 2018 objectives? And do you see a resolution actually producing upside versus the current agreement? and I guess, last part of that, does Boeing's decision on the 787 rate play a role here in complicating these discussions whether or not they actually go to 14?

Thomas C. Gentile
President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.

A

Right. Well, with regard to 2018, we're not providing guidance on 2018 yet. So, no comments on that. The issue with the negotiations as I said is, we'd like to resolve them to eliminate the uncertainty, but we don't want to do that if it's not a fair and equitable agreement. The interim arrangements are satisfactory, they enable us to meet our guidance for this year and we remain committed to that long-term goal of 6% to 8% cash conversion. So, with regard to the 787 rates, anything related to the 787 is involved in the discussions but it's not specific, the focus is really more on the pricing for the 787-9 and the 787-10.

Michael Ciarmoli
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Okay. Perfect. Thanks, guys.

Ghassan Awwad
Executive Director of Investor Relations and Corporate Strategy, Spirit AeroSystems Holdings, Inc.

A

Operator, we'll take a final question on the call today.

Operator: Got it. Our last question today will be coming from Hunter Keay with Wolfe Research. Please go ahead.

Hunter K. Keay
Analyst, Wolfe Research LLC

Q

Thank you very much. Sorry again about this Boeing question, it just seems to be such a big issue for the stock, so. Would you consider mediation or using a mediator? Tom, you mentioned that there's typical contract resolution options. But I'm just kind of curious, is there mediation involved, might there be – and I'm sorry I don't know [ph] all these (:49:28) terms, but something even as dramatic as maybe arbitration.. Is there an arbitration process involved in this somehow, even binding, just kind of figure out the options at this point?

Thomas C. Gentile
President & Chief Executive Officer, Spirit AeroSystems Holdings, Inc.

A

Well, we'll follow the contract and those things are all spelled down in the contract. But again, the first focus is the discussions at the senior levels of both organizations to reach a commercial outcome. We have good relationships, we have an active dialogue, the conversations have been constructive, they've been very fact based. And that's the first focus. And then if for some reason we can't reach to a resolution, we will revert to the mechanisms outlined in the contract.

Hunter K. Keay
Analyst, Wolfe Research LLC

Q

Okay. Thank you.

Ghassan Awwad
Executive Director of Investor Relations and Corporate Strategy, Spirit AeroSystems Holdings, Inc.

Okay. Well, this concludes our earnings call for today. Thank you for your participation. Have a great day.

Operator: Ladies and gentlemen, the conference has now concluded. Thank you for attending today's presentation. You may now disconnect.