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Spirit AeroSystems Holdings, Inc. (SPR)

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MANAGEMENT DISCUSSION SECTION

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Well, thanks for joining. I am Rajeev Lalwani, Morgan Stanley's airspace and defense analyst. Glad to have Spirit AeroSystems here today; particularly a good day to have them given the events that are out there. And we've got their CEO, Tom Gentile, with us. Tom, thank you for joining. I think you're going to go through your safe harbor statement and make a couple of prepared remarks before we get into Q&A.

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

Right. Right. Thanks very much, Rajeev, and good afternoon, everybody. It's really a pleasure to be here. Before we begin, I just want to read a quick reminder. Any projections or goals that may be included in the discussion today will likely involve risks which are detailed in Spirit's news releases and SEC filings.

So, for those of you who don't know us well, we are in aerostructures business. Really, that's what we focus on exclusively. We do commercial and military. And we're fortunate to be on all the big programs for Boeing and Airbus. So, all 13,000 of their aircraft that are in backlog, we have significant work packages. And, of course, on some of them like the 737 and A320, very significant work packages.

On the 737, for example, we make about 70% of the structure, including the entire fuselage. And, obviously, that's been a big focus right now. It's our biggest program and, obviously, Boeing has been under some strain. I mean, we see the pictures of Renton, very concerning to everybody in the industry. And, of course, we want to make sure that fuselages and the parts we deliver aren't contributing to the problem.

I mean, earlier in the year, we did have some supplier disruptions which caused delays, and we got behind on deliveries in Q1. But Q2, we actually had a very strong quarter in terms of deliveries. We delivered 169 fuselages. To do that, we had to spend more on overtime, more on contractors, some expedited freight, but we caught up on the deliveries in terms of the number of units. But this is a production system that requires, really, precision. And so, there were still times when the trains didn't arrive in the exact order, and so that could create some additional disruption.

So, this persisted longer in terms of having the contractors and the overtime and some of the expedited freight than we expected. But the deliveries, very much on track, not only on the 737 but across all the programs. So in fact, we're confident this year we're going to meet all of our delivery schedules and they're actually running a little bit better than we planned for.

So this morning, we actually adjusted guidance. And so, based on very strong deliveries, we raised the revenue guidance from $7.1 billion to $7.2 billion to $7.2 billion, $7.3 billion. But taking into account the increased cost that we've incurred through the middle part of year due to shortages, we lowered the bottom end of our guidance on EPS from $6.25 to $6.10. So now the new guidance is $6.10 to $6.35, which we think accurately reflects the situation we're in.

On cash flow, we kept the bottom end the same at $550 million, and we've done that by really sharpening our pencil on capital expenditure, working on some working capital initiatives, but we lowered the top end down to $575 million, reflecting some of the pressures. So, that narrows in where we are.

So, it took us longer to stabilize than we expected, but the good news is we are stabilizing. We see the factories being much healthier now. The shortages are vastly reduced. Where we've had some concerns with suppliers, we've actually offloaded the work or insourced it. And so, more than 1,300 parts, we've insourced or offloaded. So, that helped reduce the shortages, and that means that we can start to bring down the overtime and reduce the number of contractors. So, that is in very good shape as we go forward.

We expected the margins to increase in the back half of the year. Obviously, it's pushed out a little bit, but we will see improvement in the back half of the year more in the fourth quarter now, and we expect to be back to our historical levels next year. So, we're still on track for that; very encouraged.

The other thing that we've been working on is our Asco acquisition. This is a Belgium company, five-axis hard metal complex machining. And we announced that back in March – actually, in May. And the integration planning has been underway. We've already received U.S. regulatory clearance. We've applied for the European regulatory clearance. That's underway. They had the break in August so it's late, but they're now back at it. And we're working on the customer consents. We still expect that to close this year.

So overall, we're very pleased with our position, fortunate to be on all the top programs. Rates are going up, we're executing much better, and really looking forward to a good close to this year and a solid 2019.

QUESTION AND ANSWER SECTION

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

Okay. That's a good jumping off point, Tom. Let's start with the guide adjustment. You reiterated the outlook on the second quarter earnings call just a couple of months ago. So, it would be great to get a sense of just what transpired between now and then, and what specifically led to the higher cost versus your initial expectation?

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

A

Right. The simple reason is that the supply chain didn't recover as quickly as we had hoped. I mean, we got most of the suppliers delivering and reduced the shortages, but there were still a few that were lingering. And we have more than 20,000 parts on our 737 fuselage, but one can shut you down. And we had a couple that were – we call them big bones that were very critical to the production process early on. And so that created a lot of traveled work which we had to go and do later in the process. It takes longer when you do it later in the process. And so that required more overtime and more contractors.

So, that just lasted longer than we expected. Now, the good news is that we recovered the deliveries in terms of units, and we built back the buffer in terms of the shipping days. But to do that, it required more cost. Now, look, given the strain Boeing is under, we were very happy to spend whatever it took to make sure we were not part of the disruption anymore, and we're there at that point, but it cost us more. So that's why we made the adjustment to guidance and the fact that the deliveries are on track and we're going to have better revenues.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

Okay. So as it stands today, you are on track and you're caught up on all that slack you had in system or buffer, et cetera. Is that a fair statement?

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

A

Yes. Yes.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

Okay.

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

A

Now, the other thing I want to make clear is that, when I say traveled work, that's traveled work in our own plant. We never travel any work to Boeing knowingly. So, we address every quality issue that we find, every open piece of work. So we ship completed units to them which, to the best of our knowledge, don't have any quality issues. Now, there are escapes of course but we try to minimize those. We never knowingly send anything.

What we do is at the end of the line, we do this thing we call a shake and we do three shifts. We don't actually physically shake the fuselage, but that's what we call. We have people go in, crews that kind of scour the entire fuselage to make sure that there's no tools or foreign object debris, no shavings or leftover rivets or [indiscernible] (00:07:21) so we do that. We do three before we are ready to finally ship and then one just before we put it on the train. So, four shakes at the end.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

Okay. The other part, just sticking with the guide update, you actually took up your revenue guidance. Can you just bridge the old to the new? What drove that higher revenue number? I can't imagine your commitments on [ph] three 787 (00:07:49) or any of those that change or wherever there's surprise.

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

A

No. It's just, when we did the revenue guidance earlier in the year, we always assumed that there might be some ship-outs. And as we have now better clarity in terms of where the year will finally end, we see they're going to have all of the scheduled shipments that were originally planned. So, we didn't get as many schedule and ship-outs as we thought we might. And so, that's what drove the increase.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

Okay. And then, coming back to what you were describing in terms of your suppliers, I think at one point you were highlighting that you had 15 or so suppliers that were behind. And correct me if I'm wrong, Tom, but where is that today?

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

A

Right. It's just a handful now, okay...

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

Okay.

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

A

...but a couple of big ones and they might have raw material shortages or some capacity shortages. And that's where we've decided really to offload. That's one probably big difference between now and the beginning of the year is we've offloaded much more work faster.

And when I say offload, what it means is a supplier is delivering a part, we see that they might be struggling, not have enough capacity or staff. And so, what we do is we dual source it or we multi-source it; or, in some cases, we in-source it. And that gives us the security of supply. We've been doing that – we've done that now on over 1,300 parts.

So, it's been a pretty big effort, but that's alleviated a lot of the shortages, so we have the parts flowing. And one thing about our plant is it's very efficient. We have parts. It's efficient. And we can actually – we can execute. And they're getting the parts now, we're getting the work done in station. The work isn't traveling to later in our line and we're being much more efficient as a result.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

Okay. And when we look at just the headwinds that Spirit has encountered, how much of that is due to rate versus the transition between the NG and MAX?

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

A

Right. So, it's probably split evenly. And the reason is if you look at the MAX, I mean, it's a 737, it's the same type certificate, but it's about a 35% difference. And in all these aircrafts are going on the same lines in our factory, but it requires some different skills, and some different approaches; different work instructions, different processes, different tools, different parts. And so, there's a learning curve.

So, last year when we went to 47 it was the first time we'd ever built any MAXs. We built about 80 last year. This year, roughly about half our production will be MAXs, about 300. Next year, there will be mostly MAXs. And so, people are learning that. We had a lot of new people. And so, the combination of new people and the new skillsets that were required put a lot of strain. And so, it took longer to do things and that drove some of the overtime. So, it is a little bit of both. I mean, switching from the NG to the MAX was a significant challenge. Probably, we underestimated it. And then, also going up in rate.

The good news though is on the rate is going to 57 ironically is going to be the easiest transition for us. And the reason is when we're at 42 we had 2 lines, each line produced 21 aircraft a month, and 1 came off each day. So, they were one-day line. Each station was one day. We were there for almost five years. So, the workers got very used to it, very accustomed to doing their one day of work, and then every one day an aircraft came off every manufacturing day.

When we went to 47, we had to open up a third line and it was a four-day line. So, an aircraft only came off every four days. So, now you had people doing MAX work which was different and also working at a different pace, so created more disruption. When we go to 57 next year, we're going to have three lines but we're going to produce 19 on each line and we'll have 2 days of buffer. There'll be three one-day lines each producing 19 aircraft a month to get to the 57. So, we'll be more balanced next year than we've been in a long time, and that will drive productivity and efficiency.

The other thing is as we get into the back half of this year we've already started hiring for 57. We started a little bit early. We're always a few months ahead of Boeing anyway, but we've started even earlier so that we have more people to help us with our current production and we have longer to train them as we go on to 57. So, I'm very confident and optimistic that the transition to 57 will be our best, our best rate break in the last three.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

Boeing has highlighted that they had to provide additional resources, man power, et cetera, over – at the facilities in Wichita, et cetera; is that something that's going to cost Spirit extra? Is that embedded in the guidance? And relating to that, are there penalties embedded in your guidance as it relates to Boeing; and the other side of that is, do you have any assumptions around recouping some costs from suppliers that were delinquent and so on?

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

The answer is both. I mean, on the supplier side, certainly if some of the supplier performance cause disruption for us that cost money, we've made those assertions and claims, so we've had those conversations. And so, we're in the process of collecting on those claims and the conversations are very direct, but constructive, and people recognize where they've been involved.

Similarly, with Boeing, we've had those discussions, we built those expectations into our guidance. The type of help that they've provided has been very useful. It's not mechanics who are on the line, but what they've done is they've brought in people who are kind of experts in production or supply chain. A lot of our supplier issues are also supplier issues for Boeing. So, we've actually gone out jointly to several of the suppliers to work on the resolution that helps us and helps them directly.

But some of the people that they've brought in are actually retirees who lived in Wichita, Boeing retirees, and they went through the last transition from classic to the NG. So, they've been through this before and they've been very useful. Now that we found them, we may not give them up. So, it's been that sort of support. A lot of industrial engineers as well, very helpful. I have to say that the level of cooperation transparency with Boeing is at an all-time high. We have very good communications on a daily basis, many times during the day so that they know exactly where every single fuselage is and can plan for it accordingly. It's been very good shoulder to shoulder.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC
Q

That's good to hear. And in terms of – going back to your supply chain, how do you monitor issues? How do you monitor your suppliers such that you can be ahead of when disruptions were to arise? I mean, what are some of the things that you can do to sort of be ahead of the curve, if you will, with your suppliers?

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

So, there's a lot of rate readiness assessments. We do surveys. We do on-site visits. We do evaluations in terms of infrastructure, equipment, tooling, staffing, material. So, we do all of those sort of things. For the bigger suppliers and especially ones that get into some trouble, we have on-site teams that will go out there and actually live there for periods of time. So, those are different methods that we can use with our suppliers to ensure that they are delivering and ready. And that's very important, that we have a very strong understanding of what it is that they do.

The other thing is we have controls in place. So, for example, inventory management; one way to ensure that we have parts is to keep some surplus inventory on hand. So, we use a min/max system on inventory. So, a minimum amount that we want to hold takes into account safety stock, lead time, risk, importance, and things like that. So, we're constantly adjusting those minimum levels and the max as well. So, when we look at our inventory on a daily basis, we look at is anybody below the minimum? That's the first sign of trouble.

We also then have, we call it, delivery to load, and is anybody missing a load date. That's of course a more severe sign of trouble. So those are some triggers that give us advanced warning as to when a supplier may be starting to experience some difficulty.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC
Q

Okay. That's helpful color. Maybe a couple of more questions from me and then I'll turn it over to the audience. I wanted to come back to margins. Your guide, your expectation, is it fair to say that fourth quarter this year you're expecting to be back at sort of your margin targets overall?

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

Right. Well, it probably will be pushed a little bit. And that's why we adjusted the guidance because we expected to have the full back half of the year to recover back up, but the higher costs lasted longer. So fourth quarter, you'll definitely see improvement, but it may not get all the way back to the historic levels. We will be there next year.

So when we did the deal last year with Boeing and with Airbus a year before, our goal was to put in place a program where we could get back to our historic levels of margin for the company and for each of our segments: Fuselage, Propulsion, and Wing.

Now, in our industry as I've always said many times, you have to run fast to stand still. So, our customers always have customer price step downs, they have productivity expectations, we have escalation on material and labor. So, we have to drive a lot of productivity initiatives through supply chain, through digitization, through factory productivity, automation, all those things, in order to maintain margins.

Now, with the rate increases, we certainly incurred some higher costs for this period of time. So that's where we saw a little dip in margins. But the plans that we have, the line of sight we have are to be back to historic levels of margins.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC Q

Now, one can argue that your margins should actually be better than the previous guidance because of some of the changes in accounting, the changes in mix around the 737. Is that fair or am I getting ahead of myself?

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

Well, I mean there might be some upsides but there are some downsides as well. So, again, we look at – if we go back to 2016 – we think that's probably a pretty good year – we'd been at 42 for almost five years actually, 4.5 years. So, we achieved the level of productivity. That's probably a good benchmark and that's what we use internally is because that's what we think we can get our margins to as what they were at the run rate, say, in 2016.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC Q

Now, one would push – could push back and say at 57 or 63 whatever it is, your margin should be better than when you were at 42, plus you've got more content from a MAX and so on. How do you reconcile that? Is it just the idea of price step downs and Partner (sic) [Partnership] for Success and so on [indiscernible] (00:18:28)

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

Well those are significant headwinds; they're not insignificant as you know. So offsetting those and keeping margins where they were historically, we think is a good outcome. And next year, with the complexities of the

MAX and three rate breaks in a row, all of those pressures that you just mentioned in terms of Partnership for Success, SCOPE+ on the Airbus side, those are tough ones to overcome. So, the goal is to keep margins where they've been historically, and we think that would be a good outcome.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

Okay. We'll pause and see if anyone in the audience has any questions.

Q

Just help me understand, to the extent that you bring in parts that you were getting from a supplier internally and produce them, does that more likely than not improve or decrease your likely margin profile?

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

A

It improves it. So, we wouldn't bring it in house unless we could do it for lower cost. And very often – because we've just invested in some state-of-the-art equipment for our machining centers of excellence, the three- and four-axis in Oklahoma and the five-axis in Wichita. So, we have the latest machining. We have more volume and scale, we can buy material cheaper usually than our suppliers. So, when we bring it in house because we can do it cheaper. So, all of those generally are cheaper and so the margins are better.

If we can't do it cheaper, that's when we'll look for an outside supplier. And again, we've got a very global supply chain. We can tap – plot suppliers all over the world including low-cost countries. So, we've had very good success when we do have to offload to finding it at the same price or even better.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

I think there's another question. Up here. Right here.

Q

Hey, Tom. Could you remind us where you are with third-party fabrication and defense initiatives?

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

A

Right. So, we said we wanted to grow both of those businesses to $1 billion businesses. And we started the year off in third-party fab at about $600 million of activity. It'll end up about $670 million, $675 million; so 12%, 13% growth. So we're happy with that. Now, we expect that there will be a little bit more third-party top line revenue, but in fact because of this issue we just talked about, we've used a lot of the capacity to help out the supply chain and drive those emergent parts. So, we've seen the activity grow like we expected, so very pleased with that.

On the defense side, we grew from about $480 million to $520 million over the course of the year. So, still on track to make it $1 billion business. We're starting to see some of the programs continue to grow in terms of their development. So, for the Sikorsky CH-53K, for example, we delivered our last test article, our sixth test article. And we're now working on the first article for the low rate initial production, LRIP. And then the B-21 is still in the early stages of development.

So, those programs are all growing. We're bidding on a lot of new work, both major structural work but also third-party fab work in the defense. What we'd like to do is leverage the positions we have on some of those programs as a beachhead and then expand out with more work. And so, we've built and strengthened those relationships, and that's now something that we're also starting to work on.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

Are you on the MQ-25 with Boeing, is a T-X an opportunity – T-X trainer program an opportunity for you as well?

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

A

Well, we don't talk about those programs. The OEM will talk about who is the partners on those programs.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

Okay.

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

A

But – yeah.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

Understood. Any other questions from the audience? Okay, let's keep going. One of the other things I wanted to ask you about is just the availability of raw materials. There has been some reports of delays issues, et cetera. Can you talk to that and just give us an update on where you are?

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

A

Raw material is really the lifeblood of this industry. You have to have the raw material, whether it's – in our case, aluminum or titanium is really critical. And there have been some issues in terms of – because the production rates are going up and we have this shift in mix – model mix, not everybody has been able to order the right quantities at the right time. So that's an area we stepped in.

We work very closely with Boeing. I mean, the issue is just as critical to them. And so, they've got their TMX buying consortium. We've worked very closely with Boeing and with TMX to make sure that the materials are flowing with our suppliers and with ourselves.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

Okay.

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

A

So, some challenges, nothing that can't be fixed. It's just that you've got to get on top of it quickly.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

To the extent that you can't procure the raw materials, is that something that you're on the hook on, or is that Boeing's problem because they're sort of procuring it on your behalf?

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

A

Well, it's both of our problems. If we don't have material and they don't have parts. So, we jump on it together. It's something that we both recognize as important. And again, shoulder to shoulder, we're out there together working on the issues to solve them.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

And Tom, I've been hitting you a lot on the 737 program for the obvious reasons.

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

A

It's a big one.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

But now let's talk about some of the other programs. How is the 777X doing, particularly given the transition that we're seeing, 787 and so on?

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

A

Okay. So, 777X is, as you know, that program's been at eight, then went to seven, then to five. As we get into the transition, we're really more at a 3.5 rate. So that's been some headwind for us. But the good news is we've got the first couple of test articles that we've delivered, our work package, which includes the entire Section 41, as well as some of the wing components and the entire nacelle, including the inlet, the fan cowls, as well as the thrust reversers. So, the first couple of units are out there, and that program from Boeing is right on schedule. So, that's good.

What we've seen is, from our vantage point, a lot of emphasis on the freighter. So, we're still building the 777-300ER in the freighter, and we've seen a lot more freighters come through. So, that market seems to rebounding. We saw some very good orders at Farnborough, and that's encouraging. So, that gives us a lot of hope for that.

And then, earlier today, John Plueger, I know you talked to him about the replenishment cycle that's coming in the early 2020s for the wide-bodies. So, that should pick up orders for the 777X and probably the A350 as well, and that should get the rate back up to where it was more in the past. So, we're very optimistic about the 777X program and on track with our deliveries for that.

787, that's going to 14. And so, we're right in the middle of that transition right now. We're moving from 12 aircraft per month to 14 early next year and, again, we're a little ahead of Boeing. So, we're already working on that. We're kind of transitioning to 13 first and then to 14, and that's right on track. And that program is performing very well.

As you know, we had a large forward loss last year when we did our deal with Boeing. We've lined it up out to 1,405. But we've actually had a couple of reversals on that forward loss the last couple of quarters; one for rate, rate went from 12 to 14. But also we've been working very closely with Boeing on risk sharing to drive productivity. And so, when we get that productivity, we both realize the benefit. And last quarter, the benefits were more than we had originally planned, and so that's when we had a slight reversal.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

Coming back to the 777 and some of the comments you made around freighters versus 777-300ER. Are you indifferent between the two; is one more challenging to produce in terms of the structures or not?

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

A

Not necessarily more challenging, but there's just difference. So, biggest difference probably is the floor beams. On the passenger version, they're composite; on the freighter, they're metallic because of the loads. So it's different. It's not necessarily harder; it's different. You have to plan for it. So, we've never done as many consecutive freighters as we are doing now, so there's more of them. So, that's how we see it as is reflected in the firing line, if you will, for the freighters versus the passenger version. And we're seeing a lot more freighters.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

Okay. And then on the 787 side can you talk about the profitability of the program today from a cash perspective, and then where we're going over the next few years given some of the step downs that you've agreed to last year in the agreement?

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

A

So, that goes all the way back to the very start of the program where we had agreed to it on the Dash 8, had never clarified it for the Dash 9 and the Dash 10, but given the Dash 9 and the Dash 10 aren't that much different from the Dash 8, we just accepted it. And that goes all the way out to unit 1,405. And because of the cost and price equation it resulted in a forward loss which we've identified. So that takes us out to 1,405. The good news is that between now and then we can work with Boeing. We have this risk share arrangement to try to get the cost down below the price. And when we get to 1,405, we'll see where we are and we'll negotiate an extension and figure out what the right price is given the market conditions and the cost situation at the time.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

Okay. But from a cash flow perspective, do you think it'll be – do you have plans in place that will make it a sort of losing money on each unit maybe being a positive cash contributor? Because that's going to be tough given...

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

A

It's always difficult. We don't expect to lose money on every unit forever.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC
Q

Okay.

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

So, we've got everything locked in place with the forward loss up to unit 1,405, and beyond that, we expect we'll have the costs down lower and we'll talk about the price.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC
Q

Okay. A350, maybe an update on programs?

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

Well, that program, when we signed the deal with Airbus a couple of years ago, we had accumulated a deferred of about $700 million. There was about $250 million of forward losses taken collectively on the program. So, over the final 700 units, the goal was to collect the remaining $450 million.

And so – and when we went to the new revenue recognition from ASC 605 to ASC 606, all of a sudden the cash positive per unit turned into margin per unit. And so, that's where we are today. Program is running pretty well. Sales have been a little light, I would say. Although there were some good sales at the Farnborough Airshow. That was encouraging to see. But the rate probably hasn't picked up as fast as Airbus originally intended. But that's given us a little bit more time to catch up on our productivity issues.

And so, on the Section 15 and the fixed leading edge which are the work packages that we have, we've actually been able to build up a buffer now, a little bit of buffer; which actually is good, because as we speak, there is another hurricane barreling toward North Carolina. Now it looks to be veering off to South Carolina which is too bad for South Carolina but better for us.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC
Q

Yeah.

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

So, we'll see how that goes. But the program is operating much better from a quality standpoint, from a delivery standpoint. We built up a buffer. So, we're very encouraged with that program right now.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC
Q

Okay. CapEx; there's been some movement there in terms of the $250 million to $300 million sort of longer-term expectation. But then there's some movement post tax reform.

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

Right.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC
Q

We've had some adjustments, I believe, correct me if I'm wrong, Tom, given you're trying to manage some of your numbers. So where are we now in terms of how to think about CapEx going forward?

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

Right. Well, we lowered the guidance on the CapEx and we expect to be within that guidance. We're doing all the projects that we think are helpful and beneficial; all have great returns in terms of productivity and growth. So, that's on track. And what we did is we've been a lot more judicious. So, we've made some tradeoffs. We've also been able to reduce the cost of some of the programs. And then, the other thing we did is instead of doing cash CapEx, we did some leases, which spread the cost out over a longer period of time to align better with the benefit. So, all of those things enabled us to bring the CapEx down further, which helps cash flow, but really the goal was to manage the CapEx in a more efficient way.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC
Q

And now, is this – are the numbers this year a good run rate for next year and beyond?

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

We think next year – we're not giving guidance yet, but as we look out at 2019 and 2020, the $250 million to $300 million number still is in the right level of target because there's a lot of replenishment of facilities and equipment. We've got some organic growth initiatives, particularly on the defense side. So, all those things are taken into account.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC
Q

Yeah. And then, what we – as you've said before, what we'd have to monitor is where we go with rate on 737 and your negotiations with Boeing.

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

Right. So, right now we're locked and loaded for 57, which we go to next year. That capital – actually, most of the capital is in already and that's helping us out. It gives us some more surge capacity right now. But that's all set. If they decided to go higher, we'll have discussions about that. I mean, we have the infrastructure, the bricks and mortar; we wouldn't have to build anything on that. It would require us some more capital and tooling, and obviously some additional head count.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC
Q

Okay. NMA, to what extent are you chatting with Boeing about sort of the various opportunities for you to partner with them?

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

Right. Well, we definitely had some conversations. And what we're doing is we've put together some teams to consolidate all of our ideas, whether it's fuselages or wings or propulsion in terms of structures so that we're ready, not only for Boeing but also for Airbus, for the defense primes. And we've got some really good ideas.

I think our experience in terms of composite fabrication and metallic fabrication for fuselages, we think, is unparalleled. I mean, nobody builds a more complex section than the Section 41 for the 787. It's the cockpit. I mean, if you look at the A350, it's not a composite cap; it's metallic. Whereas on the Boeing version, it's not only an entire barrel, but we do the front part of it, the cockpit which is the most complex.

So, we have some unique skills. We also – we're in the middle of country. We're far from East Coast, which is not good. We don't have this beautiful view like in Laguna, but we have very efficient labor costs, which we think makes us also competitive. And our design engineers, we have a lot of design authority on all of our aircraft, particularly the Boeing side. They're OEM caliber because they used to be OEMs.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC
Q

Yeah.

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

And so, we bring a lot of unique characteristics. We think we can come up with some very compelling ideas and offers that would be very competitive for the NMA or the neo-plus-plus or whatever the next generation of aircraft is.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC
Q

Asco; can we get an update on where you are on the financing side and the expectations around closing the deal? You provided some color earlier.

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

Right. So first of all, on the financing, very good shape. So, when we announced the deal on May 2nd, we said we were going to also use that as an opportunity to restructure some of our debt; refinance it. And so, we went ahead with that. We raised $1.3 billion of new debt. We got it at a weighted average maturity much longer than our current and at a lower weighted average cost of debt. So, very successful. We did some 3-year, some 5-year, and some 10-year notes.

Some of it is repayable and callable. So, we can continue to pay down the debt. But the end point by the end of this year, the leverage will be about 2 times gross debt to EBITDA. So, we're very – I think we're very pleased we got it done when we did because the market has been extremely choppy. And if anything, rates have gone up. And so, I think we got it at a good time. And so that's all done. And we also funded our accelerated share repurchase at the same time. And so, that's also underway. So from a financing perspective, we're in good shape.

From the standpoint of closing the deal, we had to get some regulatory consents. We got the regulatory consent in the U.S. and Belgium. The EU is in the final stages. So, they've asked their initial questions. They've gone out and done their assessment. So, now they will complete that work. And then we had to get about a dozen customer consents and we've got a few more to go on that.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

Okay. And then close, is it fourth quarter?

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

A

Realistically, yes.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

Okay.

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

A

I mean, we won't close in September, but we expect October, November.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

[indiscernible] (00:34:56) Not sure that you can do the rate ramp, but what sort of work you've been able to do on the assets there and sort of put yourself in a position where once you do close the deal, you can hit the ground running? That's one part of it and then the other, just how's the business been performing ever since you sealed the deal there?

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

A

It's been performing very well. I mean, they have some ups and downs and they're managing through that. But they're on some great programs and those programs have been ramping up. Some ship-outs. But what we've been doing is a lot of integration planning. So, we have teams for every major function: IT, finance, HR, operations, engineering, supply chain, the main ones; and they're going through a very detailed playbook, so to speak, to make sure we're ready for day one.

The other thing that we've been looking at is, for example, their capacity, how do we make sure it's full, okay. So, they have some open capacity which is good because we can fill it. So, we have all these suppliers that some of them need help. They have a lot of the capability to do that. We've also looked at our own production system. As we are looking at increased rates saying, well, given that they have capacity now, we can leverage that which avoids us having to spend capital equipment or any infrastructure. The other thing they have which is extremely attractive to us is processing capability.

And as we've gone up in rate, one of the things that we've seen is that processing, whether it's chemical treatment or heat treatment for corrosion preventative, hardness, and things like that, there's a bit of a shortage in the market and Asco have some very good processing capabilities, so we'll immediately leverage that. So, we've got plans in place that we can immediately take advantage of their machining capacity, their processing capacity, and ensure a smooth integration.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

Maybe a last question for you and we'll wrap up. How is the M&A environment looking? Are you seeing more opportunities to buy assets given maybe some of the struggles that are out there with suppliers meeting the ramp?

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

A

Well, there's definitely a few companies that are in processes right now. But it's not a huge number. And so, we – as the kind of largest structures player with a pretty good balance sheet and a lot of capacity right now, we always get a call. So, if there's anything out there, we get a call from your colleagues and the other banks. So, we don't ever fear being left out. And so, we look at everything but right now, we're focused on execution, delivery of the current programs, and getting the Asco deal closed.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Okay. Well, let's leave it there, Tom. Thank you so much for your time.

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

Thank you, Rajeev.