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Spirit AeroSystems Holdings, Inc. (SPR)

Q2 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, ladies and gentlemen, and welcome to the Spirit AeroSystems Holdings, Inc. Second Quarter 2019 Earnings Conference Call. My name is Cole 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 note this event is being recorded.

I would now like to turn the conference over to Ryan Avey, Director of Investor Relations. Please go ahead.

Ryan Avey

Director of Investor Relations, Spirit AeroSystems Holdings, Inc.

Thank you and good morning, everyone. Welcome to Spirit's second quarter 2019 earnings call. I'm Ryan Avey, Director of Investor Relations. And with me today are Spirit's President and Chief Executive Officer, Tom Gentile; and Spirit's Senior Vice President and Chief Financial Officer, Jose Garcia. After opening comments by Tom and Jose regarding our performance and outlook, we will take your questions. In order to allow everyone to participate in the question-and-answer 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 discussion today are likely to involve risks, which are detailed in our earnings release and our SEC filings and in the forward-looking statement 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'd like to turn the call over to our Chief Executive Officer, Tom Gentile.

Thomas C. Gentile III

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

Thank you, Ryan, and good morning, everyone and welcome to Spirit's 2019 second quarter earnings call. Spirit delivered strong performance in Q2, as we continue to manage through the time period of the MAX grounding. Despite postponing our planned ramp to 57 737 ship sets per month and remaining at 52, revenue was up 10%, adjusted EPS rose 5% and adjusted free cash flow increased 13%. As you would expect, our strong focus has been on the MAX and how we respond operationally since the aircraft was grounded in March.

Boeing continues to work with regulators around the world to return the MAX to service. As we agreed with Boeing, Spirit is continuing to produce at a rate of 52 aircraft per month. We remain proud to be a partner on the MAX and very confident in the long-term outlook for the program. That said, we communicate with Boeing regularly and we'll coordinate our production rates with them on the timing of the MAX returning to service.

As I mentioned last quarter, we had all the resources in place to produce the 737 at 57 aircraft per month. While the capital, tooling, staffing and material was staged in our factory to produce at rate 57. In fact, the beginning of our final assembly line had already started cycling to produce 57 aircraft per month. Taking the factory back down to rate 52 in a short timeframe created a whipsaw effect and caused a lot of disruption in a complex production system like the 737, especially the fuselage.

So, the second quarter was really a transition quarter for Spirit, absorbing those associated disruption costs. Additionally, in the second quarter, we industrialized the process for transporting and storing the excess fuselages, since Spirit is producing at 52 aircraft per month right now and Boeing has reduced down to 42 aircraft per month.

First, we transport the fuselages on flatbed trucks from our factory to a designated wrapping area for protection from inclement weather. Our engineers designed a unique three-layered wrapping process, which takes approximately four hours to complete: the first layer is an acetate material to protect the skin; followed by a thick Styrofoam layer; and finally, a cushioned concrete tarpaulin layer for additional protection.

The fuselages are then tethered down to a special holding fixture cradle, where they're typically stored between 10 to 20 days before being unwrapped and shipped to Boeing by rail. We have stored and shipped now over 130 units and currently have roughly 35 in storage. We continue to build at the rate 52 agreed with Boeing. However, we'll continue to monitor and work closely with our customer to determine the appropriate production rate, given the MAX return to service schedule.

Last quarter, we also laid out our cost reduction plans to mitigate the impact of the lower 737 production schedule. The 737 is approximately 50% of our revenue. We built 70% of the aircraft structure, which is down about 10% from the previously expected rate of 57 to rate 52. So, we are targeting around a 5% reduction in total fixed costs at Spirit to offset this new production level.

These actions include: reduced levels of overtime and contractors; a voluntary retirement plan; 10 unpaid furlough days for certain employees, including the entire senior leadership team; a hiring freeze; deferred capital spend; and working capital improvements. While we implemented these cost reduction and working capital improvements in the second quarter and they are tracking to plan, the financial benefits will be realized beginning in the second half of this year.

These financial benefits will carry into the future as our resources become better aligned with the lower level of production. We will also benefit from a longer period of rate stability and we will begin to see improved quality and production efficiency as well as margin improvement back toward our target of 16.5%.

We will continue to take full advantage of this pause in rate increases to focus on improving quality, factory efficiency and supply chain health. We are already seeing the 737 fuselage line cycling in-station better than we have seen in the last three years with fewer part shortages from our supply chain.

Now take a closer look at second quarter results. At $2 billion, revenue was up 10% over the second quarter of 2018. Adjusted earnings per share was up 5% at $1.71. Our adjusted segment operating margin was 15%, which was impacted by the transition back to 52 aircraft per month in the 737 program and the early maturity of the cost reduction actions.

If we stay at the current production level of 52 aircraft per month in the 737 program, we expect margins to improve throughout the second half of the year as we realize the full benefits of our cost reduction actions.

Given the uncertainty regarding the 737 MAX, we are unable to provide guidance at this time. We will provide updated financial guidance when we have further clarity on the timing of the MAX return to service and the 737 production schedule for the rest of the year. We do not anticipate that we were producing at a rate any higher than 52 per month in 2019.

Additionally, we will continue to produce at rate 52 in order to burn off excess stored inventory after Boeing eventually transitions to rate 57. Given current production and storage levels our expectation is that we will not produce at a rate higher than 52 during 2020, but our goal is to achieve a 65.5% margin rate in 2020. Jose will provide a more detailed financial overview in a few minutes.

Turning to the topic of growth, the 737 program has been a strong driver of organic growth for Spirit over the last few years and will continue to be into the future as well. The delayed production increased to rate 57 has pushed that growth out further than previously planned. During this time, we have not slowed our focus on our other growth priorities, including defense and fabrication. Additionally, we have a strong balance sheet to do inorganic acquisitions that meet our strategic and financial criteria.

In the absence of suitable acquisition targets, we remain committed to returning 100% of our free cash flow to shareholders through dividends and share repurchases, which we will resume after certification of the MAX. Whether it is through share repurchases or inorganic growth, we will deploy our capital to benefit earnings and free cash flow per share.

And now, turning to the status of the Asco acquisition. As you may have seen reported, Asco experienced a cyberattack in June. Prior to the attack, we had worked with the European Commission to finalize methodology for data segregation to meet the conditions of their approval, which they provided in March. The cyberattack delayed this process. As a result, we extended the long-stop date of the contract to October 29. Asco is in the process of recovering their systems after the cyberattack and we expect that they will restart the data segregation process once they have completed that activity.

The seller will bear all costs associated with the cyberattack, which we expect will be covered by the indemnity we put in place, which is capped at $150 million. We believe Asco remains a compelling strategic fit for Spirit, as the acquisition expands our Airbus content, adds new defense content and broadens our fabrication business.

And now, few other recent highlights. We announced our collaboration role on the Airbus Wing of Tomorrow program, contributing across four technology projects, supporting commercial aviation applications.

Our participation on Wing of Tomorrow marks an important milestone in our support of Airbus. We are leveraging our full suite of distinctive capabilities to improve product performance by lowering cost and shortening development cycles. Using digital design and manufacturing approaches, we are developing the product in parallel with the production system. This collaboration is an addition to the 70,000 square-foot Aerospace Innovation Center at our Prestwick, Scotland facility, where we broke ground last year.

The site is focused on resin infusion processes for composite materials, part handling, assembly automation, rapid prototyping and virtual and augmented reality will all directly support the company's wing development and industrialization efforts.

We also announced the development of new production methods for carbon fiber composite material that will enable lower cost and higher production volumes for future aircraft components. We unveiled what we call the Advanced Structures Technology and Revolutionary Architectures or ASTRA, demonstration fuselage panel, using this new proprietary architecture at the Air Show in June. This new disruptive technology for step change improvements in terms of cost and weight on fuselage panels.

With that, I'll ask Jose to lead you through the detailed financial results. Jose?

Jose Ignacio Garcia

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

Thank you, Tom, and good morning, everyone. Let me summarize our second quarter financials. Let's move to a slide four, please. Revenue for the quarter was $2 billion, up 10% from the same period of 2018. This was driven by higher production volumes on the 777 and 787 programs. Favorable model mix on the 737 as we transition to the MAX from the NG and higher revenue recognized on the 787.

Let's now turn to EPS is on slide five. We reported adjusted EPS of $1.71 per share compared to $1.63 in the second of 2018. This represents a 5% increase year-over-year. Adjusted EPS excludes as in prior quarters, the impact of the Asco acquisition. Also excludes the impact of the previously announced voluntary retirement program. The voluntary retirement program is a non-cash expense that will be funded from our overfunded pension.

The adjusted EPS improvement year-over-year was primarily due to favorable model mix on the 737 program and lower share counts, partially offset by the non-repeat of favorable changes in estimates recognized in the second quarter of 2018. The current quarter also includes a favorable litigation cash settlement of approximately $14 million.

In the second quarter, we implemented cost reduction actions to mitigate the MAX impact on earnings partially, and we will realize the benefit of these actions beginning in the second half of the year and continuing into next year.

Now turning to free cash flow on slide six. Adjusted free cash flow was solid for the quarter at $193 million compared to $171 million in the second quarter of 2018. This reflects a 13% increase year-over-year. Adjusted free cash flow excludes the impact of the Asco acquisition. The adjusted free cash flow growth was driven by working capital, lower cash tax payments and lower CapEx, partially offset by increases in inventories from our 737 supply chain, fewer 737 deliveries as a result of the MAX rate adjustments as well as 787 price step downs.

Additionally, we increased our receivable factoring in anticipation to help offset some of the MAX related inventory headwinds in the second quarter. This is a temporary measure, which will be relieved once the cash advance is received from Boeing in the third quarter.

Let's now turn to capital deployment on slide seven. We ended the second quarter with a healthy cash balance of $1.3 billion and we remain very confident in our ability to fund our current operations. Our strategy of maintaining a strong balance sheet provides us with substantial borrowing capacity through capital markets access and our undrawn credit facility of $800 million. We also paid $13 million dividends in the second quarter.

As we discussed last quarter, we have paused our share repurchases until we have further clarity surrounding the regulatory approval of the MAX return to service. We maintain our long-term balance capital deployment strategy and have returned greater than 100% of our free cash flow to shareholders over the last three years, which has been an important contributor to earnings per share growth. We have $925 million remaining on our current share repurchase authorization.

Now, let's look at our segment performance. For our Fuselage segment results, please turn to slide eight. Fuselage segment revenue in the quarter was $1.1 billion, up 7% from the same period last year. This was due to higher production volumes on the 787 and A350 programs, as well as higher revenue recognized on the 787 program.

Operating margin for the quarter was 12.4% compared to 15.8% in the same period last year, due to higher costs related to the 737 program largely resulting from the impacts of the 737 MAX grounding and the non-repeat of favorable changes in estimates in the same period of last year.

On a normalized basis, after reversing changes in estimate from prior years, Fuselage segment margins improved slightly to 13% in the second quarter compared to 12.8% in the first quarter. We expect further margin improvement in the second half of the year as our cost mitigation actions are realized and efficiency improves from a stabilized 737 rate.

Now turning to slide nine for our Propulsion segment results. In the second quarter, Propulsion revenue was $519 million, up 23% compared to the same period last year, primarily driven by favorable model mix on the 737 program, higher production volume on the 777 program and higher revenue recognized on the 787 program.

Operating margin for the quarter was solid at 18.8% compared to 17.7% in the second quarter of 2018, primarily due to favorable 737 model mix as we transition from the NG to the MAX. On a normalized basis, after reversing change in estimate impacts, Propulsion segment margin was 20%, continuing the strong performance from the first quarter.

For our Wing segment results, let's turn to slide 10. Wing revenue in the quarter was $399 million, up 4% compared to the same period last year, driven by higher production volume on the 777 and 787 programs. Operating margin for the quarter was 14.4%, compared to 14.8% in the second quarter of 2018. On a normalized basis, after reversing change in estimate impacts, Wing segment margin was 13.8%.

Let me conclude by reminding everyone that our previous 2019 guidance did not reflect the impact of the delay on MAX production rate increase. As we announced in 2Q and due to the remaining uncertainty, on the timing of the MAX return to service date by the FAA. And Boeing's production schedule and the impact to Spirit, we expect to issue financial guidance at a future date.

In summary, while there is still more work to do, we're making progress on the cost and cash [Technical Difficultly] (19:22) actions we first laid out last quarter. To better align with the lower 737 rate of 52 aircraft per month.

I want to thank the team for their efforts, the entire Spirit organization and the broader supply chain that have really stepped up and embraced these challenges to help mitigate the impact of the scheduled changes. We will begin to see the financial benefits of these actions to improve throughout the second half of the year and into 2020.

With that, I will turn it back over to Tom for some closing comments.

Thomas C. Gentile III

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

Thanks, Jose. And I'll make some closing comments before we take questions. Q2 was a transition quarter. Once we learned the MAX was grounded, we stopped all the work to increase the 737 production rate to 57 aircraft per month. The factory was already loaded for that rate with all the inventory from supplier states. The rapid change in direction created significant disruption. We had all the cost in place for rate of 57, but never made the transition and remained at 52. The negative impact on revenue and profit as well as margins was predictable.

We quickly agreed with Boeing that Spirit would remain at a production rate of 52 and began taking the necessary actions to align our cost and working capital to the new level of production. We also made immediate operational changes to mitigate the impact of the new production levels. Those actions helped us achieve strong financial results in Q2 and positions Spirit better in the future as the impact of the actions we have taken begin coming into effect.

While Boeing continue to work with global regulators to get the MAX recertified, there is still a great deal of uncertainty around what future production schedules will be. For now, we remain at a rate of 52 aircraft per month on the MAX and continue to improve quality, increase efficiency of operations and stabilize our supply chain as we continue to pursue our growth initiatives.

Spirit is proud to be a partner on the MAX program and remain confident in its long-term outlook. With the air traffic continuing to grow at strong rates around the world, the global aerospace market remains strong and Spirit is well-positioned to be a leader in the future with significant work packages on all the Boeing and Airbus programs.

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

QUESTION AND ANSWER SECTION

Operator: We will now begin the question-and-answer session. [Operator Instructions] And our first question today comes from Jon Raviv with Citi. Please go ahead.

Jon Raviv
Analyst, Citigroup Global Markets, Inc.
Q

Hey. Thanks. Good morning, everyone.

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

Good morning.

Jose Ignacio Garcia
Senior Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.
A

Good morning.

Jon Raviv
Analyst, Citigroup Global Markets, Inc.
Q

On being able to achieve 16.5% margin in 2020, just kind of curious on what you're able to do in terms of putting the pieces in place to do that even at rate 52. And therefore, when you eventually get to rate 57 presumably, is there potential upside to that margin or is that going to be a dynamic of having to run fast and stay in place at that point? Thank you.

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

Right. Well, a little bit of both. As we outlined, this year, we started to take actions to realign our whole cost base to the new production schedule. So, as I mentioned, we built 70% of the MAX and we're very proud of that. It represents 50% of our revenue and production rate going from 57 to 52 basically takes that down 10%, so it really represents about 5% of our total activity. So, that's our target, as we look at cost reduction was to take out 5% of our fixed cost.

And so, all of the different things that I outlined in my remarks were part of that. We focused on indirect costs, in overtime, contractors, we implemented a voluntary retirement program, we had almost 200 people take that up, we also have these 10 unpaid furlough days for our salary staff including the entire senior leadership team. So, all of those things start to get the fixed cost base down.

And then on the direct cost base, we're letting attrition take its natural course. We've slowed down hiring. We haven't completely stopped it, but attrition is taking the head count down to what we require for 52 aircraft per month. We've reduced contractors and we've also been able to cut overtime by more than half. So, we've seen some significant benefits on that. So, our goal really is to end the year at 16.5% margins and to have that continue all of next year.

As I mentioned, given the current production schedules what we have stored when Boeing is likely to go back to 57 after the MAX is back in service, we expect we're going to be at 52 aircraft per month for all of 2020 and that'll give us a long period of stability. It will give all of these cost reduction actions a chance to take hold. And with all of that, we'll stay at 16.5%. That's what we'll target to achieve.

Now as we go to 57, the goal will be to try to maintain that 16.5%. As you recall when we did our deal with Boeing at the end of last year, we tied the pricing in the discounts to rate. So, as rates go up, the discount would go up as well. We've been working on our cost reduction plans to offset that and those are in place. So, we feel confident that 16.5% is a good long-term target for us at rate 52 for next year and also at rate 57 in the future when we're back to it.

Jon Raviv
Analyst, Citigroup Global Markets, Inc.
Q

Thanks. I'll hop back in the queue.

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

Thanks.

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

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC
Q

Hi, good morning, guys.

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

Good morning, Rajeev.

Jose Ignacio Garcia
Senior Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.

A

Good morning.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

Tom, a question for you. Boeing, as you talked about the idea of a potential production halt if they're not making progress on the 737. If something like that were to happen, I mean, what would the strategy be? How would you navigate that? And maybe just thoughts on how serious Boeing may be as far as looking at something like that or do you think they're maybe just trying to create some urgency around getting that process move forward?

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

A

Yeah. Rajeev, well, first of all, it remains a very dynamic situation. There is uncertainty as long as the Boeing continues to be grounded and that uncertainty isn't going to go away until the FAA and the other regulators around the world recertify it for flight. So, we're working really closely with Boeing on production schedules and what that could look like in the future in a whole different range of scenarios. So, we've been doing that scenario planning and we're going to be prepared to respond to whatever they do. We've looked at slowing down production. We've looked at doing some temporary pauses in production. So, we have all of that prepared to be able to implement depending on when the MAX gets back into service. And again, it's really about coordinating closely with Boeing and aligning the production schedule to whatever the return to service scenario ends up being.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

Tom, just a follow-up to that, you mentioned looking at a scenario of pausing production, can you provide a bit more color? What sort of – what specifically did you look at? How long of a period? Now, how complicated doing something like that? I imagine there's some element of it already of around vacation times and holidays, etcetera.

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

A

Right. Well, just to be clear, our current plan is to produce at 52 aircraft per month. And then once Boeing goes back to 57, we'll stay at 52 until we burn down the stored aircraft that we have and then we'll go to 57. So, the various scenarios that we've been looking at are just that scenarios and how we would respond. One thing, I would say is, at the end of the year, we have a one-week factory shutdown where we do maintenance.

And so, we know how to do a temporary shutdown like that, it's just very similar to what we do at the year-end. So, we've evaluated a range of scenarios; but again, to reiterate, the current plan is to stay at rate 52, as we've agreed with Boeing, and then to return to 57 after Boeing has returned to 57 and we burn down all the stored aircraft that we have.

Rajeev Lalwani
Analyst, Morgan Stanley & Co. LLC

Q

Thank you.

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

Okay. Thanks, Rajeev.

Operator: And our next question comes from Sheila Kahyaoglu with Jefferies. Please go ahead.

Sheila Kahyaoglu
Analyst, Jefferies LLC
Q

Hi. Good morning and thank you for the time. Free cash flow...

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

Good morning.

Sheila Kahyaoglu
Analyst, Jefferies LLC
Q

...on-track and trending ahead of expectations. I guess, as we look at the second half, how do you think about mitigating any risk to free cash flow, with regards to working capital, if you could talk about that a little bit, Jose?

Jose Ignacio Garcia
Senior Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.
A

Yeah. So, I'm glad you asked, because the progress on working capital continues to be good. I think the team has a good plan attacking all the elements of working capital, especially on our supply chain, days to pay. We continue to make progress and in fact, that's accelerated. And it's remarkable, because we're also managing the ramp down from 57 to 52, without – in a thoughtful way with our suppliers.

The CapEx deferrals are in place and you saw quite a bit of tailwind in the second quarter on that. Again, we are deferring maintenance CapEx, which is about half of our CapEx spend per year. We do have tailwinds going into the second half and the future, because a lot of the CapEx in addition to maintenance was associated with rate increases, which at this point we see kind of a stable forecast at least going into 2020.

And the big challenge we had in the second quarter was with inventory. We took a lot of inventory earlier in the quarter as we did kind of a vertical drop in the production schedule from 57 to 52. And we expect that to liquidate itself throughout the third and fourth quarter.

So, as I mentioned in my remarks, we did replace some of the inventory usage with additional factoring. We expect that to unwind in the third quarter as Boeing advances cash to manage the supply chain. And in summary, our framework for the year stays in line with the earlier guidance that before we suspended it of $625 million to $675 million for the year.

Sheila Kahyaoglu
Analyst, Jefferies LLC
Q

And just as a follow-up on free cash flow, I guess, how are you thinking about working capital as it relates to the 777 production from legacy to the MAX?

Jose Ignacio Garcia
Senior Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.
A

So, we lose obviously the volume and that is irreplaceable. The inventory impact we've seen in the second half we will absorb.

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

Yeah. That's for the 737. For the 777...

Jose Ignacio Garcia
Senior Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.
A

For the 777.

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

Yeah. For the 777, we're managing it very similar to the way we managed the transition from the NG to the MAX. In other words, as the 777-300ER goes down, we reduced the min/max levels on that. And as the 777X production starts to ramp up, we increased the min/max inventory levels. So, manage one down and the other up and we are able to therefore kind of manage that transition in bridge on the 777.

Jose Ignacio Garcia
Senior Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.
A

Yeah. That's correct.

Sheila Kahyaoglu
Analyst, Jefferies LLC
Q

Okay. Thank you.

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

Carter Copeland
Analyst, Melius Research LLC
Q

Hey. Good morning.

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

Good morning, Carter.

Jose Ignacio Garcia
Senior Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.
A

Good morning.

Carter Copeland
Analyst, Melius Research LLC
Q

Just to expand quickly for clarification on the 777X, is there any – are you proceeding on development spend and plan as originally planned ahead of this last slippage in first flight or has there been any change in your work scope at all?

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

A

No change for Spirit. We're proceeding on the original plan and we're right on track.

Carter Copeland
Analyst, Melius Research LLC

Q

Okay. And then just one on the voluntary retirement just to make sure we have this calibrated right. You said that will be funded by overfunded pension. Is there a P&L impact there or is that shown somewhere else?

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

A

Right. Well, as I said, about 200 people took advantage of the voluntary program that we offered. And all of that will be funded from our overfunded pension. But there was an incentive component to it to basically provide motivation for people to accept it and also to bridge them to Medicare if they were under-65. And that is also funded out of the overfunded pension plan, but the impact of that incentive portion of it hits P&L. Now, it's about $15 million.

Jose Ignacio Garcia
Senior Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.

A

15, yeah, 1-5.

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

A

So, that was an adjustment that we made to EPS.

Carter Copeland
Analyst, Melius Research LLC

Q

Okay. Great. All right. Thank you very much, guys.

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

A

Right.

Operator: And our next question comes from Seth Seifman with JPMorgan. Please go ahead.

Seth M. Seifman
Analyst, JPMorgan Securities LLC

Q

Thanks very much and good morning.

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

A

Good morning.

Jose Ignacio Garcia
Senior Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc. A

Good morning, Seth.

Seth M. Seifman
Analyst, JPMorgan Securities LLC Q

I wanted to ask if you can just level set us may be on Asco, in terms of thinking about how things are going there this year and when we start to think about it coming into the results next year. We had been thinking about Asco having about $440 million of sales and EBITDA margin in the high-teens for 2019 and then growing into 2020. Is that still a fair way to think about what they might be contributing?

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

Yes. Yes. So, as I said, the outlook hasn't changed and it's still a very good strategic fit. What happened is we were in the process of working on the conditions that the European Commission had put in place for approval and that involves segregating the commercially and technically sensitive data that Asco may have encountered over 40 years of being in this fellow Airbus structure with a company called Sonaca.

And so that was going on, then the cyberattack hit and it basically delayed it. So, unfortunately, we had to push the long-stop date out and we put an indemnity in place and we've got a good set of contractual arrangements in place.

We have a pretty good estimate, Asco started to get an estimate of the cost of the cyberattack, but they're very manageable. They're going to bear those costs and the outlook in terms of revenue, profit, cash flow still looks very similar to what it was before the cyberattack took place. So, yes, what you just outlined for 2020 is a good set of assumptions.

Seth M. Seifman
Analyst, JPMorgan Securities LLC Q

Okay. Great. I'll [indiscernible] (35:09). Thanks very much.

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

Thank you.

Operator: And our next question comes from Myles Walton with UBS. Please go ahead.

Louis Raffetto
Analyst, UBS Securities LLC Q

Good morning. This is Lou Raffetto on for Myles.

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

Hey. Good morning.

Jose Ignacio Garcia
Senior Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc. A

Good morning.

Louis Raffetto
Analyst, UBS Securities LLC Q

So, just in the press release, you guys point out the lower margins in Wing Systems and sort of – attribute that to performance on the A320. So, I was just hoping you could elaborate a little bit there?

Jose Ignacio Garcia
Senior Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc. A

Yeah. The revenues on A320 were as expected. Now, the Wing – the margins on the program were impacted by pricing true-ups that related to prior years, mostly 2018 and will not repeat in the future. We're not reflecting them [indiscernible] (35:53), because it's really on blocks that have been closed, but practically is equivalent. We have a complex pricing agreement that incorporates trailing FX adjustments and there were some disputes in the methodology that we call [indiscernible] (36:16).

Louis Raffetto
Analyst, UBS Securities LLC Q

Okay. Great. So, nothing operationally at least?

Jose Ignacio Garcia
Senior Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc. A

No.

Louis Raffetto
Analyst, UBS Securities LLC Q

All right. Good. Thank you.

Operator: And our next question comes from Ronald Epstein with Bank of America Merrill Lynch. Please go ahead.

Mariana Perez Mora
Analyst, Bank of America Merrill Lynch Q

Good morning. It's Mariana Pérez Mora for Ron today.

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

Good morning.

Jose Ignacio Garcia
Senior Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc. A

Good morning.

Mariana Perez Mora
Analyst, Bank of America Merrill Lynch

Q

Good morning. I have two questions today. One is a follow-up on Asco. On the cyberattack, how – shut down like four facilities in four countries? Could you provide details on that? How severe were the damages? How can you mitigate risk like this in the future?

And the second one, given 737 MAX issues, could you please update us on the status of the NMA and new narrow-body replacement program?

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

A

Right. Well, in terms of Asco, the cyberattack was one that has hit a number of companies around the world. Our initial understanding is it's either BlueKeep or [indiscernible] (37:23), which are different versions of a cyberattack. What it did is it basically infected the systems and caused them to shut down and they didn't have access to some of their systems that were connected to the Internet.

So, what they did essentially was recreate their programs going back to their backups before those cyberattack had occurred and also reconstructing their data again leveraging their backup files from before. So that took some time. What they did is they went to manual production, so they could get their production back and they've been able to keep up relatively well with production along with help from Spirit and from several other customers. So, that all worked well. And as they get all of that process complete, they can go back to working on the data segregation that we agreed to do with the European Commission.

So, it was a disruption for a few weeks where they had to use some manual methods as opposed to being able to leverage their systems, but we expect that they will be able to fully recover from this process. They've got a lot of good advisers and a very strong team. We're very – Spirit has been supporting them as much as we can. And again, we expect a full recovery for them to be able to resume normal activities including the segregation process for the European Commission. So, that's where we stand with Asco and I want to give a lot of compliments to that team. They've worked very hard through this time period.

With regard to the NMA and new single-aisle programs both at Boeing and Airbus, Boeing continues to have discussions on the NMA. Spirit, of course, would be very interested to be a partner. We think we have a compelling value proposition, where really the world's leader in aerostructures, both metallic and composite, the media reports are that that will be a composite aircraft. And again, we have a lot of experience, especially on complex structures like the forward fuselage, which is what we do on composite on the 787. So, we feel we could provide a compelling value proposition and we are eager to be able to present our ideas to Boeing on exactly what shape that would take. Obviously, our business case would have to close for it to make sense. It's not a win-at-all-cost program, but it would be something that we would really look forward to working with Boeing on.

With regard to new single-aisle programs, Boeing and Airbus are in development phases on those. Those are long ways out of course, but they're in development phases. I mentioned in my remarks something called, Wing of Tomorrow. That's a program that Airbus has to think about next-generation structures. They also have a Fuselage of Tomorrow program and a corresponding one on propulsion. And we are involved in all three areas with Airbus as they think through their next-generation structures.

Mariana Perez Mora
Analyst, Bank of America Merrill Lynch

Q

Thank you very much.

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

Robert Spingarn
Analyst, Credit Suisse Securities (USA) LLC
Q

[Technical Difficulty] (40:27-40:36).

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

Hello. Robert, we're having some difficulty hearing you. There is a lot of tinging in the voice. Can you try again, please?

Robert Spingarn
Analyst, Credit Suisse Securities (USA) LLC
Q

Can you hear me better? Is that any better?

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

Yes. That's better. Yes, absolutely.

Robert Spingarn
Analyst, Credit Suisse Securities (USA) LLC
Q

Okay. Okay. Sorry about that. Just you talked about being at 52 for a while past Boeing. When I think about the excess aircraft that are building up whether they're in Wichita or in Seattle, the excess fuselages. And based on their expected return to 57, I think it's at the end of next year on their plan. Some of us think it will take a little longer. I see about 21 to 24 months of excess fuselages. So, is it possible that you don't get to 57 until a couple of years after they do?

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

Well, the math is going to be, however, many we have stored when they go to 57, it will take us that amount of time dividend by five to return to 57. So, it really just depends when they go to 57 and how many we have stored at that time. So, as I said, based on the current production levels and how many we have stored and how many we'd expect to have stored, I would think for 2020, we're going to be no more than 52 for the entire year. Beyond that, it really depends on when the MAX gets back into service and when Boeing starts to increase its rate and eventually gets to 57. And those are still uncertain at this time.

Robert Spingarn
Analyst, Credit Suisse Securities (USA) LLC
Q

Well, yeah. It seems to me it'll be well over 100 fuselages, that's the math that we'd be dividing by five. One other thing I wanted to ask you is just on the 777 to clarify the 16 per quarter versus 12 previously, you just – the higher rate of 777s?

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

Per quarter, well, I mean, the – we always think in terms of months.

Robert Spingarn
Analyst, Credit Suisse Securities (USA) LLC
Q

Five per month versus...

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

Yeah.

Robert Spingarn
Analyst, Credit Suisse Securities (USA) LLC
Q

Yeah. Five per month instead of 3.5, what's driving that?

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

Well, it's just right now we're going through this transition the bridge from the 777-300ER to the 777X. And this was always planned, especially with the development units were back up to an effective rate of five. Whereas last year, we were really in an effective rate of 3.5, so I think it's right in line with the plans that Boeing has had and has been communicating for some time.

Robert Spingarn
Analyst, Credit Suisse Securities (USA) LLC
Q

Okay. Do you see any risk that you have to drop back down to 3.5?

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

Right now, we don't. I know they did announce that their first flight is going to be delayed. But as of this date, we haven't really changed our production schedule or development plans.

Robert Spingarn
Analyst, Credit Suisse Securities (USA) LLC
Q

Okay. Thanks, Tom.

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

Thanks.

Operator: And our next question comes from Doug Harned with Bernstein. Please go ahead.

Douglas Stuart Harned
Analyst, Sanford C. Bernstein & Co. LLC
Q

Good morning. Thank you.

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

A

Good morning, Doug.

Jose Ignacio Garcia
Senior Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.

A

Good morning.

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

Q

I wanted to go back to Wing Systems. In Q1, you talked about the improved performance there and that was in margins and that was coming from the A350. And then in this quarter, you talked earlier on the call about – and you said it in the release that the headwinds which appear to be one-time on the A320, but there also was a reference to one-time on the A350, some non-recurring expenses in the presentation. So, what I'm trying to understand is what do you see the trajectory of Wing Systems margins as being here? Should we expect to see upside continuing like we did in Q1 and Q2 as somewhat of an aberration? How should we look at this?

Jose Ignacio Garcia
Senior Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.

A

We had, like you said, impacts on both A350 in 1Q and A320 in the second quarter. Really, the positive in our Wing segment, despite the first half is that revenues are going up as rate goes up, and we expect margins to expand consistently with revenues. So, I would just look at 1Q and 2Q as unusuals and non-repeats and look at the revenue trajectory as the guide for margin expansion.

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

A

Yeah, we were confident, Doug, in the Wing programs, particularly the A320. So, we do expect to get back up to our historic levels on Wing margins.

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

Q

Do you have a sense when, what this trajectory would look like?

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

A

Well, I think this year, again, obviously, all the difficulties we experienced. By the end of this year, we should be back up to our historic levels and into next year.

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

Q

Okay. All right. Great.

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

And then by the way, you've seen Propulsion margins as we've been communicating have continued to improve and that trend will continue that they will be proportionately higher than they were historically in Propulsion.

Douglas Stuart Harned
Analyst, Sanford C. Bernstein & Co. LLC
Q

And that's due to the 777X and the MAX nacelle, I assume that's still the main driver of that better performance.

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

Yes. Exactly.

Douglas Stuart Harned
Analyst, Sanford C. Bernstein & Co. LLC
Q

Okay. All right. Great. Thanks.

Operator: And our next question comes from David Strauss with Barclays. Please go ahead.

David Strauss
Analyst, Barclays Capital, Inc.
Q

Thanks. Good morning.

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

Good morning.

Jose Ignacio Garcia
Senior Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.
A

Good morning, David.

David Strauss
Analyst, Barclays Capital, Inc.
Q

Tom, I wanted to follow-up on this idea that Boeing could halt. Does Boeing have the contractual right to have you pause and not accept ship-sets from you?

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

Yes. I mean, the way the contract works is they have to give us notice. But obviously in this situation, things are very dynamic. And we work closely with them. We coordinate with them. But they can contractually change the rates with appropriate lead times. Now going up in rate, obviously, we have to make sure that we have enough lead time to get capital and tooling and staffing in place. Going down, they have more flexibility. There is a lead time. But again, in these types of situations, we just work with them to figure out what's the right answer.

David Strauss
Analyst, Barclays Capital, Inc.

Q

Okay. Can you quantify roughly what that lead time is?

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

A

We don't even pay attention to it. We just work with them depending on what their needs are. And so again, as I said, we've been working closely with them. We've reiterated that right now the appropriate production rate for us is 52 and that's what we plan to do. If the MAX return to service gets delayed, obviously, Boeing will re-evaluate and we'll work with them to figure out what our appropriate production levels going to be going forward.

David Strauss
Analyst, Barclays Capital, Inc.

Q

Okay. And I don't think you touched on this yet, A350 negotiations with Airbus in terms of maybe extending that block. Could you tell us where those stand and when those might wrap up?

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

A

Right. We've initiated those. We're right now at about unit 400. So, we've got quite a long time before we get to 800. But both of us recognize it would be good to start to have a dialogue about what the contract will look like going forward beyond 800 for both the section 15 and the fixed-leading edge on Wing.

So, the dialogue has started. We don't necessarily have a timeframe to complete it, but we'd like to do it as soon as possible. We've got a long time. We don't reach 800 until 2021 or 2022. So, there's no pressing need. But just in the interest of getting everything stabilized, we've initiated the discussions and both of us are highly motivated to get them completed in a timely manner.

David Strauss
Analyst, Barclays Capital, Inc.

Q

Thanks.

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

A

Welcome.

Operator: And our next question comes from Ken Herbert with Canaccord. Please go ahead.

Kenneth G. Herbert
Analyst, Canaccord Genuity LLC

Q

Hi. Good morning.

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

A

Morning, Ken.

Jose Ignacio Garcia
Senior Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.

A

Morning.

Kenneth G. Herbert
Analyst, Canaccord Genuity LLC

Q

Tom, I just wanted to follow-up with a question on your supply chain specifically on the 737. Two parts, I wanted to know, if you've seen any change in your suppliers' either behavior or ability to sort of execute or invest with the maintaining of 52 a month?

And then second, as you think about the supply chain and the potential risk of a temporary pause in production, I mean, how can you – what can you comment on how we should think about your supply chain and the ability to support the program or maybe the risk levels around that with considering some of your different scenarios?

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

A

Right. Well, first, I'd like to say that our supply chain has been outstanding throughout this whole process. We've worked with them very closely. They've maintained their production schedules. They've worked with us as the schedules have changed and the rate has stabilized at 52. Most of them had already – all of them, in fact, have made the investments to go to 57. So, they are ready to go just like we were. And what they're doing is settling in at 52. So, that is in place and will continue. So again, we're closely communicating with them just like we are with Boeing.

In terms of risk, we look at the risk of suppliers in terms of financial health. So, we essentially grade all of our suppliers and there are some that are in a more precarious financial situation than others. So, we watch them very carefully. We work with them in terms of programs. On inventory, for example, we have a lot of programs that have vendor-owned inventory.

In certain cases, we can switch that to Spirit-owned inventory [Technical Difficulty] (50:15). We've really tapered and staggered the changes in inventory consumption that we have to ensure that the suppliers remain healthy. And that was as partly what Jose was describing as the advance from Boeing that we'll receive next quarter will help offset some of that.

So, we are watching the supply chain very carefully. We're watching the financial health of all the suppliers and we're taking individual actions where necessary to help that. Another thing we have, for example, is a program for factoring receivables. We work with Bank of America and we've been able to extend that program to our suppliers similar to the [ph] Citi (50:58) program we have with Boeing, but that's another way that we can help them with cash flow and liquidity during this period.

Kenneth G. Herbert
Analyst, Canaccord Genuity LLC

Q

Okay. Thank you.

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

A

Thanks, Ken.

Operator: And our next question comes from George Shapiro with Shapiro Research. Please go ahead.

George D. Shapiro
Analyst, Shapiro Research LLC

Q

Yes. The 737 deliveries at 147, a lot less than a 52 rate. Is that just timing?

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

A

A little bit of timing. But I would say, George, really mostly disruption from the pause that we had. So, once we scale back from 57 to 52, it just created a lot of disruption because the factory was already loaded and there was a lot of movement around. The other thing is we immediately started the storage process and got up to 20, 25 relatively quickly. So, we're way ahead of Boeing.

And we had an opportunity to essentially rebalance the line, get quality improved, improve efficiency as we took down contractors and overtime. So, we probably ended up producing at a slightly lower rate, that's where we got to the 147. The other thing is, as we got to the end of the quarter, there's always four or five units that are, for whatever reason, straggling.

Normally, we would kick up overtime and get those out the door; but this quarter, obviously with all the storage units and trying to manage cost a little bit, we didn't do that. And so, some of those units that would have normally shipped didn't, that's a timing issue, they'll ship in Q3. But that's really why the delivery was a little bit lower than just a pure 52 rate.

But for the back half of the year, assuming we stay at 52, we will have that rate in place. So, I would expect that the deliveries for the second half of 2019 will look pretty much like 2018, because we're at 52 for the back half of last year and we'll be at 52 for the back half of this year.

George D. Shapiro
Analyst, Shapiro Research LLC

Q

Okay. And then a follow-up with – for Jose. It reads like there was some 787 revenue recognized unrelated to the production volume differences. And I was wondering, if that's so, how big that was and how long it continues?

Jose Ignacio Garcia
Senior Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.

A

Yeah. This was the same situation we explained in the first quarter. As a result of the MOU with Boeing that was finalized at the end of last year, we simplify the pricing on the 787 and remove the risk sharing mechanism that was going in parallel to the unit price, so we merged both and the new unit price incorporates both elements. The economics have not changed. And overall, there is an increase on revenue per unit that is what you see in the ledger.

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

A

Yeah. Previously, the risk sharing meant that Boeing would pay us an amount based on losses the following year. It was very complicated and inefficient operationally. So, when we did the Collective Resolution 2.0 last year with them, we redid the pricing so that we just receive it when we ship the units, simpler, cleaner but it resulted in revenue coming forward on the 787. That was it. It's just a purely mechanical issue based on the change in the pricing structure.

George D. Shapiro
Analyst, Shapiro Research LLC

Q

Okay. Thanks very much.

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

A

Thank you.

Jose Ignacio Garcia
Senior Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.

A

Thank you.

Operator: And our next question comes from Peter Arment with Baird. Please go ahead.

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

Q

Yes. Good morning, Tom and Jose.

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

A

Morning.

Jose Ignacio Garcia
Senior Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.

A

Good morning.

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

Q

Just circling back to your comments around the storage, have you – in terms of your capacity, your ability to store a lot more units, can you kind of give us a little bit of an understanding there and how that works? And then also, regarding just the absorbing these disruption costs, is that something you're going to be able to kind of recoup. Obviously, those costs are going to continue. It sounds like here in the near-term? Thanks.

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

A

Right. Well, with regard to capacity, right now when we store the – when we wrap the units, we bring them out to a ramp, which exists adjacent to McConnell Air Force Base. And it's a very large ramp. It's owned by the landlord of several of the buildings that we lease for our different programs. And they generously given us use of it and allowed us to store the fuselages there, but the wrapped fuselages on the cradles that I mentioned. That process takes about four hours and we've – as I said, we put them in place in a first come – first-in, first-out basis. So, they're there for about 10 to 20 days and then we bring them back to the hangar, unwrap them and then ship them by rail to Boeing.

We have about 35 right now that are stored out there. But we can – really, we don't have a physical limitation. It's a very big ramp space. The limitation will just be, what's the appropriate number that we should store and we'll work that out with Boeing. But we don't have any real physical constraints. As I always said Kansas is very big, very flat, and this space, in particular adjacent to McConnell Air Force Base has plenty of room. So, we're very fortunate for that and it'll support whatever scenario we agree with Boeing.

In terms of the disruption cost, a lot of those costs are working through the system. As we go forward, the workforce, the direct labor force will align to the new production rate and we're taking all the other cost actions to absorb it. The storage costs, while it's a lot of work, they're really minimal. It will only be $3 million or $4 million total for all of this year. So, these are not really material costs as we go forward.

And the other disruption costs will eventually dissipate as we get into the stable production system. The one thing I will highlight though is, we're going to be at 52 for an extended period of time. We really went middle of last year, we're middle of this year. So, we've been there a year. We'll be there another – at least another year-and-a-half. That is going to enable us to become much more productive and also enable us to be better in terms of quality.

So, we're working very closely with Boeing on how we take advantage of this time period, not only to improve the efficiency and the quality of our production system, but also right through our supply chain. So, we're making sure, we fully leverage this opportunity, where there's a pause in production rate, while we wait the MAX to return to service.

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

Q

Appreciate the color. Thank you.

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

A

Thanks.

Operator: And our next question comes from Hunter Keay with Wolfe Research. Please go ahead.

Hunter Keay
Analyst, Wolfe Research LLC

Q

Thanks. Just a quick one and then a follow-up. Tom, earlier last year, you said you set up a team of about 40 engineers on NMA. I'm curious how the scope of that, from a staffing perspective has changed if it has since the MAX grounding?

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

A

No. Nothing really changed. We still have a very large team that's working on proposals that we can deliver to Boeing. The MAX grounding is operational, it's immediate, it's a very dynamic situation, but we can't really let it impact our long-term growth strategy. So, we've continued to work on developing ideas for the NMA, for the Wing of Tomorrow, the Fuselage of Tomorrow for Airbus also working on our defense initiatives and also our long-term R&D. So, the answer is no, we haven't let the MAX situation impact the work that we're doing on the next-generation programs for Boeing or Airbus.

Hunter Keay
Analyst, Wolfe Research LLC

Q

Okay. Got it. And you actually brought up my follow-up. In the context of those – the Wing of Tomorrow, you also mentioned Propulsion. Can you elaborate on that? In terms of some of the maybe early design requirements you're hearing in terms of the Propulsion of Tomorrow, if you will, in the context of sort of...

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

A

Well, I have to say, when I say Propulsion, I mean the structures for Propulsion, which, in this case, would be nacelle and thrust reverser-type things. So, that's how...

Hunter Keay
Analyst, Wolfe Research LLC

Q

Yeah.

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

A

...It's nothing to do with engines. So...

Hunter Keay
Analyst, Wolfe Research LLC

Q

Right. No. No. No, yeah, no, I know. I was just wondering just broadly speaking from a – even from [indiscernible] (59:09) perspective, what are you hearing in terms of that? I'm just curious broadly to speak of Propulsion. From your perspective, how do you expect to participate in that for you guys at Spirit? Thanks.

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

A

Well, again, our expertise in Propulsion is on things like pylons, nacelles and thrust reverser. And so, we work – again, we try to bring our ideas to Boeing and to Airbus in those areas. And it has to do with things like new composite fabrication technologies, new methodologies for channeling air in the thrust reversers, and we're leveraging ideas like 3D printing, resin infusion composite fabrication, new materials and also digitization techniques. So, we're applying all of those in the Propulsion area.

And the discussions are very good. Again, we think we're a leader in the field. We think we have a compelling value proposition and we look forward to providing our ideas to Boeing and Airbus in those areas.

Hunter Keay
Analyst, Wolfe Research LLC

Q

Thanks, Tom.

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

A

Thanks.

Operator: And our next question comes from Cai von Rumohr with Cowen and Company. Please go ahead.

Cai von Rumohr
Analyst, Cowen and Company, LLC

Q

Yes. Thanks so much. So, you delivered 25 more 737 fuselages to Boeing last year than they delivered to customers. And clearly, you must have done 10 more than they produced in the first quarter and here in the second even with the 147 probably 20. So, I mean, as I do my math that adds up to like 55 or 60 that should be stored and you mentioned that is 35. Are you aware, does Boeing basically take delivery of some of those stored fuselages and then they sit around in their plant, because 35 looks like a smaller number than I would think that it would really be?

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

A

Right. Well, they don't store any extra in their plant, because they have a very tight production schedule in slow days. But you're right, Cai, there is an amount that is kind of en route, if you will, on railcars, traveling or there could be some that get held for a period of time at different stations along the way. So, there's always some that are in the system, and right now, there may be a few more. So, yes. There's some in the system, perhaps a couple that they stage outside of their factory waiting to be loaded. And so that's how you get to the differences. What we have stored on site here would sound the railcars on the way, what could be held in buffer at different stations along the way, and then what [indiscernible] (61:54)?

Cai von Rumohr
Analyst, Cowen and Company, LLC

Q

Got it. And then they've talked about increasing production from 42 once the grounding is lifted in increments and suggest they wouldn't be at 57 if they ever get there until late in the year, which would suggest your amount of stored inventory is going to continue to build. Any thoughts about doing things? I know you have vacations in the fourth quarter, anything you can do to kind of cut back production from that number without disrupting the basic process?

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

A

Right. Well again, we're going to work very closely with them based on when the MAX gets back into service and when they increase their production all the way to 57. So, that's one of the reasons we didn't want to give guidance is it still dynamic. There's still some uncertainty and we will adjust the production schedule to what works best for the whole system in conjunction with Boeing.

Cai von Rumohr
Analyst, Cowen and Company, LLC

Q

Terrific. Thank you very much.

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

A

Okay. Thank you, Cai.

Operator: And our next question comes from Noah Poponak with Goldman Sachs. Please go ahead.

Noah Poponak
Analyst, Goldman Sachs & Co. LLC

Q

Hello, everyone.

Jose Ignacio Garcia
Senior Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.

A

Good morning.

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

A

Hi Noah.

Noah Poponak
Analyst, Goldman Sachs & Co. LLC

Q

I guess I'll sort of ask a similar question, but a different way, which is I'm curious if you could just provide your view based on your expertise and experience in the supply chain of assuming the current plan holds, what's a realistic thought process for how quickly and what Boeing has to go through to get back to 57?

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

A

I don't want to speculate on that. Obviously, Boeing's production schedule will depend on when the MAX gets back into service. And just like any complex production system, you need to take it up and down normally in a very methodical way. So, you can't just go from 42 to 57. There has to be some increments in that and I'm sure that's exactly what they're thinking, so that they're taking that into account.

Really, what we're focused on is we're staying at 52 right now and we will stay there beyond the point that Boeing goes to 57 and then burn down the additional buffers. And again, the equation is going to be very easy. We'll just take the number that we have stored. And once they go to 57, it will be that number divided by five will be the number of months. That's why, I'd say, based on where we are right now and how many we have stored already and what we're likely to have stored, we're not going to produce any more than 52 per month the rest of this year and we're expecting that that will be the case for all 2020 as well.

Noah Poponak
Analyst, Goldman Sachs & Co. LLC

Q

Tom, you've spoken to the 16.5% margin next year. Mainly, you could speak to the free cash flow margin you think would be associated with that, because you've got the – you've got working capital or cash tax – CapEx acting as tailwinds right now, I guess I'm sort of curious what those are doing for you next year?

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

A

Right. Well, again, the goal is to stand at 7% to 9% free cash flow conversion as a percent of sales next year, even at the lower production rates. So, a lot of work to do to achieve that, but that's the plan and it's achievable.

And I would say this again, staying at 52 will provide us with a period of stability and that is really invaluable. It will enable us to prove improve quality, but also improve efficiency and that will ultimately help margins and overall performance.

And if you go back to 2016, we had been at rate 42 for over 3.5 years and we achieved really great levels of efficiency. Now that we're pausing at 52, it enables us to repeat that and to achieve similar levels of efficiency. That's why we're able to say that we can aspire to 16.5% margins next year even at rate 52 and be confident of achieving it.

Jose Ignacio Garcia
Senior Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.
A

The only thing I'll add is obviously margin improvement will help cash flow, but we're also working multiyear working capital initiatives that will continue, not only in inventory management and payables; but also when you look at the CapEx forecast, we're going to be harvesting the deferrals into 2020 and the lower rate expenditures.

Noah Poponak
Analyst, Goldman Sachs & Co. LLC
Q

Okay.

Jose Ignacio Garcia
Senior Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.
A

So, in summary, I think, within the 7% to 9% range, there is good momentum going into 2020 at higher margin rates.

Noah Poponak
Analyst, Goldman Sachs & Co. LLC
Q

So Jose, I should be assuming working capital tailwind and CapEx tailwind 2020 versus 2019?

Jose Ignacio Garcia
Senior Vice President & Chief Financial Officer, Spirit AeroSystems Holdings, Inc.
A

Yeah. So, at the minimum, not the headwind. I think, we'll really work to make it sustained improvement, which looking, for example, our inventory turns are quite low, so there is an opportunity to improve modestly half a turn per year for several years. So, that's something that we're kind of on the early stages of achieving.

Noah Poponak
Analyst, Goldman Sachs & Co. LLC
Q

Got it. Thanks so much.

Operator: And ladies and gentlemen, this will conclude our question-and-answer session, thus concluding the conference. We'd like to thank you for attending today's presentation. You may now disconnect your lines at this time and have a great day.