Honeywell Leadership Webcast Series
Mike Madsen, Honeywell Aerospace President and CEO

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Operator: Good day and welcome to the Honeywell leadership webcast series Aerospace Conference Call. Today's conference is being recorded. At this time, I'd like to turn the conference over to Mark Benza. Please. Go ahead, sir.

Mark Bendza: Thank you, Aaron, and good morning everyone. Welcome to the first installment of our newly launched Honeywell leadership webcast series. The purpose of these webcasts is to provide our investors with an opportunity to hear from a wide range of Honeywell leaders on special topics of timely interest. With me here today are Honeywell Aerospace President and CEO, Mike Madsen, who will highlight his vision and priorities for the aerospace business. And Jeff Sprague, founder and managing partner of Vertical Research Partners, who will lead the discussion on topics that are top-of-mind for investors. But before we begin the discussion, please note that today's webcast and presentation, including any non-GAAP reconciliations, are available on our website at www.Honeywell.com/investor.

Please also note that elements of our presentation contains forward-looking statements that are based on our best view of the world and of our businesses as we see them today. Those elements can change and we ask that you interpret them in that light. We have identified the principal risks and uncertainties that may affect our performance in our annual report on Form 10-K and other SEC filings.

Mike, Jeff, thank you for being here today. Before we dive into Jeff's questions, Mike, let's take a few minutes upfront for you to outline your strategic priorities since taking over the aerospace business in late 2019. Over to you, Mike.

Mike Madsen: Thank you, Mark. Thanks for being with us, Jeff, and thanks to all of you that have dialed in. Just a few words upfront about our strategy and priorities for 2020 and beyond. First of all, we remain very excited about the portfolio that we have today, both in terms of our products and offerings, but also the markets that we serve. We feel well-positioned relative to the new platforms that are being introduced into service today, IoT and connectivity solutions that provide strong macro tailwinds for positions that we do have on those aircraft, and then also just the opportunities to continue to serve the operators of those aircraft. In terms of the Joint Strike Fighter and the Airbus A350, the Boeing 777X, the Airbus A320/A321, 737 MAX, that will hopefully be returning to service soon, and then helicopter programs like CH 47 and our missiles and munitions platforms. We continue to have leading positions in these high-value markets with products including APUs, business jet engines under 11,000 pounds, defense systems, integrated cockpits, and connected applications in every market vertical. Continued strong focus, I would say also, on business performance, including margin expansion and profitable growth. We've seen margins expand through commercial excellence and that will continue with productivity improvements both in labor and material, our engineering excellence initiatives and our fixed-cost Power of One initiative, which is focused on driving down fixed costs, while at the same time, introducing the concepts of agile development and more efficient and timely product introductions. This is an area where we have a lot of emphasis right now around product cycle time and bringing exciting products to markets on time.

We're also accelerating our supply base improvements and the ISC transformation to reduce inventory, improve backlog position, and lower costs. We actually have an initiative going now that will result in the dual-sourcing over 90% of our purchased material over the next few years. And I'm very excited about the flexibility and the productivity benefits that's going to drive. And last but certainly not least, innovative investments for next-generation and long-term growth. We continue to make large-scale investments in next-generation military and business jet engines, electric and hybrid electric propulsion and power generation systems, and advanced inertial and GPS-denied navigation to complement the products that we have today in that space. (I'm) very excited about what that's going to bring to bear in the existing markets, but also in the growing urban air mobility market.

We have innovative solutions under development right now with key macro trends of urbanization, climate change and connectivity and breakthrough initiative investments in electric aircraft, sustainability, and reduced fuel burn on existing and new engines, and of course, more navigation solutions.

To give this some perspective, we are launching breakthrough initiatives every year that target $100 million per initiative, within a five-year horizon. We have typically 12 of those going concurrently. So if everything was to hit its target, it has potential to drive a billion dollars of growth within a five-year horizon. And of course, we love that vitality and regeneration where revenue from new product introductions.

So with that, Jeff, I will turn it over to you for some questions.

Jeff Sprague: Thank you, Mike. Thanks for inviting me here today. Mark, thank you also. Busy times out there for sure. I think very top of investors' minds, of course, is what's going on with the coronavirus situation. I understand it's very fluid, but I wonder if you could share your thoughts on what you're seeing, how you're reacting, and just kind of a general landscape out there.

Mike Madsen: Yeah, it's certainly a dynamic environment right now. And so what we try to do is look at it objectively. I don't think anybody can really forecast what this is going to do and what it's going to mean for us in the aerospace industry. It's an emotional topic and it's one that's driven by consumer sentiment. So we're really focused on just trying to run the business as effectively as we can, and continue to stay focused on execution.

But I can provide a little bit of perspective on what this means in the context of Honeywell and Honeywell Aerospace. First of all, about 25% of our business is tied to the repair and overhaul cycle. If think about coronavirus and the operation of aircraft, it's really, the place where you see is in the repair and overhaul environment, not necessarily in OEM or initial provisioning or engineering revenues or anything tied to space or anything like that. So you sort of think of it as 25% of our business is R&O, and of that, a little more than half is pegged to the air transport space. So we're really talking about an environment here, or excuse me, a phenomenon here that affects about 15% of our business. And so it's not-- it's not like it affects our entire business and we're, of course, pushing very hard to offset the effects that we are expecting to see with overdrive and retrofits, mods, upgrades, engineering services, connected, decoupled revenue opportunities, and things of that nature. So we'll see. It's hard to tell right now, and I think the market is still trying to get a read on exactly what it's going to mean for us and how long it will last. But it doesn't really affect the long-term fundamentals of the company.

Jeff Sprague: And do you think there will be an aftermarket slice beyond the R&O piece, just kind of general spares and the like or what's going on, from an inventory standpoint?

Mike Madsen: Yeah, we're not really expecting to see a change in the initial provisioning and the delivery of new aircraft. The piece parts spares that we sell to the channel partners that do repairs will be part of that repair and overhaul cycle. And I think that will snap back. I think if there's any dip in that, it's going to come back once the-- once the environment starts to get a little more clear.

Jeff Sprague: Great, thanks for that. Shifting a little bit, just to the general tenor of your aftermarket business, before the coronavirus situation emerged, you know, there's some evidence that just by my tracking, industry work we do, that the aftermarket is kind of lagging in general trends to some degree, but that does seem to have changed in the last year or two. We have spoken a lot about some of your initiatives, do you feel that is actually bearing fruit with some other dynamics going on in your aftermarket businesses?

Mike Madsen: Yeah, I think it's a couple of things. First of all, it's, it's challenging to compare aftermarket performance between the businesses because of the exposure they have to different platforms and the timing of that revenue, of course, not being synchronized with the airplane deliveries. That said, we're pretty happy with our business results in the aftermarket. You know, (overall) we saw about 9.5% organic growth and 21% op income growth, 240 basis points expansion last year. And importantly, we did that with 100% free cash flow conversion.

In terms of the aftermarket, which I would say includes spares and repairs business both, up a little over 10% last year, which was, I think, well in excess of the flight hour growth rate. And I think that speaks to the fact that we have a pretty strong portfolio of mods and upgrades out there. Last year a big part of that was the ADS-B mandate. That's winding down, but we've got others coming along in terms of the FANS upgrades, still going strong there, weather radar, LED lighting, and some really exciting upgrades that we have for the Epic cockpit, both on the fixed wing side and rotary side. On the rotary-wing side, and what we're calling the Phase 8 upgrade for the AW139, for example, really helps integrate synthetic vision with the rest of the system which is really timely right now I think.

I want to also say that we're excited about the future here. We have some great positions on platforms like the joint strike fighter, and the A350. Those are going to start to generate aftermarket revenue for us in 2020 and beyond. So what we tried to do, as we've talked about before, is drive decoupled revenue by focusing on connected and mods and updates to be able to bring more value to our customers that isn't just tied to flight hours.

Jeff Sprague:

I know we've heard a fair amount from others last year, that the MAX grounding impacted some element of the aftermarket that seemed to be mostly an engine maker issue, but did you see that in your business? Essentially deferring maintence because they needed to keep everything available flying?

Mike Madsen:

We actually saw pretty high volume from aftermarket work last year on the NG which continues this year as well as on the 320s that are out there, that are out of warranty. These airplanes that are flying that are seeing very high volume of utilization. And over 90% of our AT&R R&O work (flat-rate and MSP) is under an LTA.

You know, in the air transport space, just to give you a little perspective, about 75% of the work is done in our shops, and 25% is done through the channel, through an authorized provider, or someone who use our parts, or airlines choose themselves to do the work. But that OEM piece was quite strong last year, and remains so in 2020

Jeff Sprague: Shifting to the MAX situation now, the Company provided some color on the last earnings call that I think everybody on the line has at this point but if you could share how you see this kind of playing out, assuming Boeing does kind of ramp back up on schedule, the effects this might have on the aftermarket and how ready are you to ramp things back up?

Mike Madsen: Yeah, I'll start with the last part first. We've been working very closely with Boeing in terms of readiness, and I can say that Boeing's been very effective in reaching out to the entire network to ensure that all of their partners are ready to go. And this is 2 pieces: return to service and return to deliveries. And deliveries will start ramping back up here in March and April at a rate that Boeing's giving us for airplane components to be delivered to them. But we also have a strong partnership with them in terms of getting the aircrafts ready for return to service. We've been out there on the airplanes making certain our equipment is functioning as it should. Our field support people are working with Boeing. So I'm excited about this because it's a very tight partnership there and Boeing has done an excellent job, in terms of driving that collaboration.

So, in terms of what that means for Honeywell, we're tied out with Boeing on the airplane forecasts that they have given the entire community. That's what where we're working to, and we will expect to see, I think as that the airplane does come back online, there'll be a lot of pressure from the airlines to take more of those planes. They're very efficient. It will save a lot of fuel and as fuel prices go up, it will continue to be a bigger deal. So I think the pressure will be there to take more sooner. In terms of what it means for Honeywell overall, there is an economics headwind on the topline for us for MAX deliveries this year being down, with deliveries being a lot lower than we had originally anticipated. But we also see that aftermarket activity maintaining a very high level. So at least bottom-line, it's just a little less in terms of headwinds.

Jeff Sprague: The headwinds, are significantly lower, does that imply will ramp actually come up faster?

Mike Madsen: Right now, we're just working to the Boeing forecast, in terms of our deliveries to Boeing. But I wouldn't be surprised as the aircraft comes back in service, to see the ramp up sooner, particularly with the aircraft that have been parked that were in service.

Jeff Sprague: Fair points, but do we then see more older planes parked as MAX comes back, reciprocal vulnerability on the other side?

Mike Madsen: I don't see it necessarily in terms of vulnerability. We planned for that downturn. You know, we had always planned for Max deliveries to be there. The fact that they have been scratched this quarter is totally an anomaly, but when they come back online, and this is a long process – this doesn't happen in a few months, but of course the NGs will start to fly less as the MAX flies more and there will be the normal shifts in the aftermarket that you'd expect to see there. But again, in the great scheme of our overall business, I don't think that will be a big impact, it certainly won't be outside the range we provided in our full year guidance.

Jeff Sprague: Shifting gears a bit, when the industry has continued to consolidate really at an unbated pace and we're well aware of the multiple combinations that happened. You know, Honeywell has argued for years that you're competing on technology, not scale. But is that view in any way evolving? How does M&A fit into your strategic planning process?

Mike Madsen: Yeah, I think my view would be the same, which is that scale for scale's sake isn't necessarily what we're interested in. I do think scale is good, to a certain degree. We have that within Honeywell. I mean, Aerospace, that's a $15 billion business here at Honeywell. It's good from a couple of perspectives. One is the diversification that it gives you, particularly if you're exposed to multiple end markets and the multiple products gives you the opportunity to bring comprehensive solutions to your customers, which they like.

Scale also provides improved fixed cost absorption and everything else that comes along with having a good-sized business. You know, your G&A rates are lower, your fixed costs in general are lower, it's a good thing from that perspective. Regarding scale as a driver to leverage a customer into getting more business, I don't think it really works. Customers are going to buy what they want. It's a competitive market, they're going to choose wisely. And I speak to this as someone who has an avionics business, a wheels and brakes business, an APU business, an engines business, a lighting business and environmental control systems business. You know, so scale also has some challenges involved. And so, we like the business that we have. We continue to think of M&A in the context of technology, technology synergies in particular. And I think about products like navigation, electric propulsion and power generation. Those two areas in particular, I think, are attractive to us. Here's kind of how we looked at it. We looked at where we think the world is going to be in 5, 10, or 20 years, and where we can play, and where we can really excel. And we look at the gaps that we think we have in technology or manufacturing capability, or talent. And then we try to close those gaps as intelligently as we can. Sometimes it means developing it ourself. Sometimes it means buying or acquiring a company, and sometimes it means partnering. We're going to be doing a lot more partnering going forward as well. I think there's an environment there that allows us to work more collaborative-- collaboratively with our customers and some of our peers to bring some of these solutions forward, and you'll see more of that. And we have made some acquisitions. We recently acquired TruTrak, which was a great add-on for our Bendix King autopilot family. We're certainly looking at, any given time, dozens of properties that could bring that technology to our portfolio and they do bring scale, too. But you know, the two plus two equals five comes from the idea of buying some technology and then leveraging across multiple products and multiple markets and make more of it than the original owner could, so—

Jeff Sprague: Along those lines, I think one of the things that's maybe driven companies into each other's arms is the view that the end customer, the OE, who's got designs on, you know, those aftermarket businesses and felt the need to kind of push back against that. Do you see that as a risk to your business? I mean, clearly you're working on business model evolution with power-by-the-hour type offerings and software related offerings. What's your view of kind of that whole dynamic and how the busines might change and how you might protect the family jewels for lack of better term?

Mike Madsen: Yeah well, you know, the OEMs being part of the aftermarket story isn't new, and it will continue to increase. And I think for good reason. I do think that the OEMs bring a strong value proposition to certain customer segments, the ability to have this nose-to-tail solution, I think is particularly attractive for airlines that may not have an engineering organization and purchasing organization, or who can't or don't want to solve those problems on their own. We don't really look at that as competition. We work with Boeing, we work with Airbus and Embraer, you know, to be part of their solution, to sort of backstop that in terms of maintenance, but also in terms of just being able to provide technical support. So this is-- this is a way we reach our customers. Of course, we also go direct, you know, we work directly with those airlines that want to work direct. And we've seen that there is a balance right? There's a whole range. So we don't necessarily see this as competition, but rather we need to work with the OEMs to partner and be more effective in terms of bringing that value to them. They can't do everything on their own, and neither can we.

You know, to give you some numbers, in the air transport space, about 75% of our maintenance work is done in our own shops, and the other 25% in the network. But when you take that total, over 90% of it is under a long-term contract. So, you know, we have strong contractual relationships with the airlines and with our channel partners, and so we know we have some fairly high confidence that works's going to be coming in, and of course, they have confidence in us to supply the material and do the work. And that includes the power-by-the-hour and the flat rate at agreements that we have. It's both.

You know, I think that where we really excel is as an OEM on our equipment, that's a unique advantage that only we, Honeywell, can bring. We designed this product, and when we service it, we're able to take that information and understand how that product is performing relative to its design intent. And, I think the airlines value that. That comes with the Honeywell 8130 tag that we have, and they know that we backstop it. Also, things like our SPEX program, which gives customers access to mechanical components and maintenance, and the Honeywell Avionics Protection Porgram which provides the same thing for avionics , the ability to get an exchange unit, have questions answered on the phone or through email with somebody while they're standing there and that all comes with doing business with Honeywell.
And of course, the other thing that comes along with this aftermarket, which again, we're working with the airlines directly with MROs and with the OEMs is Forge. The Forge maintenance services and the flight efficiency offerings. And I think that's going to be a real game changer in our ability to participate in that space.

Jeff Sprague: Thanks. Can you atually elaborate on that a little bit more since you brought it up. That was on my list – some of the new initiatives, in particular, JetWave, how these are really playing into your view and how commercially important are these, at this point in time?

Mike Madsen: Yeah, I'll give you some sense of how this plays out for us. If you think of Forge and the PTMD program, the Performance Trend Monitoring programs that we have out there, that are now part of Forge, between the two, if you think about the maintenance side of Forge, we have about a 119 airlines, and over 9,000 thousand aircraft using one of those systems, either Forge or PTMD or some combination of those. And on the flight efficiency side, 37 airlines and 2,900 aircraft are using that system today. To give you some idea, the airlines that are using Forge and PTMD on the components that they've applied it to, that we've worked with them on, we're seeing as much as a 30% reduction in unscheduled maintenance on those components. And you think about an unscheduled event, and not only does the repair costs less, but the cost of dealing with the repair comes down….the crew costs, passenger inconvenience, everything. On the flight efficiency side, what we're typically seeing is about 2% to 2.5% fuel savings. This is from optimized climb, optimized descent, optimized cruise, and routing support and optimization. And I really think we're just scratching the surface here with this. So we're actually very excited because we've done on our own and by partnering with OEMs and by partnering with major MROS, we're able to bring their intellectual capabilities and put that into Forge and really multiply the capabilties and the savings for the airlines. So it's pretty exciting.

Jeff Sprague: And these by their nature would be subscription-type models?

Mike Madsen: Yes. Yeah, they are, and it's good for them and it's good for us. It's good for us because it's predictable revenue and it's good for them, because they know that they're not going to have these spikes in the maintenance side and they know that they are guaranteed savings on the flight efficiency side.

Jeff Sprague: Great. You talked a little bit about your margin aspirations for the business. There's a long-term target out there of 27%. It's been a pretty impressive, 25.7% last year, but maybe some positive mix on the ADS-B and aftermarket we talked about before. How do we get to 27%. And maybe even why is that the right number? How did you come to that as the target for the business?

Mike Madsen: Yeah, that's our near-term target, I would say. Our mid-term target, maybe. It doesn't stop there. When we do get there, we're going to set a new bar and keep going. There's still a lot of opportunity here. No question that the aftermarket mix and ADS-B last year helped margins, but we've gots mods and upgrades this year too - we've got the FANs mandate that's not done, we've got the RDR 7000. We've got mods and upgrades for our APUs, we've got the EPIC Phase 8 upgrades. But, I would also say, there's a lot of opportunity beyond mix, in terms of gross margin expansion. Honeywell Aerospace does a tremendous job, if you look at our income statement, converting gross margin to operating income. We do a great job there. We really have a ton of opportunity in gross margin. I would say around material productivity in particular, the ability to execute on our the supplier transformation and ISC transformation initiatives that we launched last year that are going to start to pay dividends in 2020 and beyond, relative to gross margin expansion. And then we also continue to improve/lower fixed costs, right? We're going to continue to become leaner and leaner relative to fixed costs in-- in every aspect, not just G&A, but our real estate costs, repair and maintenance costs for our facilities. And so I'm still very bullish on our ability to sustain margin expansion.

Jeff Sprague: Let me tie that back to kind of where we started, with coronavirus and the uncertainty, certainly Honeywell has been very well-known for- for maybe lack of a better term, brute force restructuring right, in getting things done. It's becoming much more sophisticated, I would say, within the greater supply chain and some of these sorts of things that you're doing, but maybe give us a little sense of how you can react to uncertain dynamics? Are you able to kind of accelerate some of these initiatives and how flexible are they?

Mike Madsen: Yeah, a couple of things here. First of all, we've got some great built-in flexibility, just in the way we're structured. You know, for example, with the events in China, we have repair overhaul facilities there, but we have repair and overhaul facilities in other regions that can do the same work. So it's pretty easy for us, in the short term, and I mean, in a matter of days or weeks, to be able to move work from one facility in one region to another. Similarly on the manufacturing side, we typically have backups in place that allow us to be flexible.

If you look at our workforce, we'd like to have small, but not insignificant amount of subcontract labor available that we can flex up and down to deal with peaks in workload, and then be able to cycle back down when we see that work load go away. And the nice thing about that is it really reduces the impact on our regular workforce when we see these events occur. That's really built into what we do. And of course we try also working with folks like yourself and the industry partners to understand what what the future is going to look like. We're not trying to be reactive, but rather to be proactive, and being prepared a couple of years out. We run a process where we're routinely looking at our business environment, beyond a 5-year horizon, so that we can make great long-term investments in technology, but also in our footprint and our talent, so that we have the right people at the right time.

Mark Bendza: Jeff, we can probably do one more question.

Jeff Sprague: Great. Why don’t we chat about defense and space, then, just briefly, with the time we have. Obviously, a very diverse business with a different set of drivers going on. Got a good update on the Q4 call, but maybe you could give us a little bit more granular view of what types of issues you might have with the multi-year horizon and what stands out as kind of an area of strength for you?

Mike Madsen: Yeah, a couple of things. I’ll kind of start at the macro level and work down. First of all, U.S. defense budgets remain very strong. We saw the recent news about programming there and some changes relative to the enacted versus the proposed budgets. Those generally are good for Honeywell. We have some really enduring positions on attractive platforms, like the F-18, like the Joint Strike Fighter, like the Chinook, all of which remain well-funded in the budget.

The other thing I would say has been a strong point over the last couple of years, will remain strong, is our guidance systems, in the missiles and munitions area of the business. Not just domesticially, but internationally. You know, the US consumes those products, but we’re also producing for our allies, particularly the Five Eyes countries and Israel, and that will remain a point of strength for us. So I don't see that changing in the near-term.

We do have some very exciting upgrade programs that we're working on in the helicopter engine family. And I don't want to say too much about that, only to say that we have the ability to bring in, particularly the U.S. Army, a very significant savings in terms of fuel efficiency, maintenance cost, and power on their engines, and in the short-term and long-term. And that of course, will also benefit foreign MODs. So I think the world remains a turbulent place. And while that's the case, the defense business will continue to stay strong. And similar to our commercial business, we focus on not only just the OEM, but also the service and support, through the PBLs that we operate, the performance-based logistics programs we operate for the DOD, and of course, these mods and upgrades. So, we keep focused on that. I think it will continue to be a great business for us.

Jeff Sprague: Thank you for your time, Mike.

Mike Madsen: All right.

Mark Bendza: Well, we'll wrap it up there. Thank you, Mike and Jeff, for the discussion and thank you to everyone on the line for joining on the leadership webcast with Mike Madsen and Jeff Sprague. We’re excited about the opportunities ahead for our aerospace business and look forward to continued strong performance under Mike's leadership. We will now conclude the webcast and we hope you will tune in for the next webcast, which we will announce that a later date. Thank you.

Operator: Ladies and gentlemen, this concludes today's call. We thank you for your participation. You may now disconnect.