

# Embraer (ERJ)

## Alert: JetBlue Deferral Highlights Backlog Quality Issues, Associated With Larger Orders

JetBlue's decision to defer deliveries of 24 of its 25 E190s left in Embraer's firm order backlog is negative for Embraer, as it highlights backlog quality problems associated with large orders. We remain sellers of Embraer.

On Tuesday, prior to the market's open, newswires reported that JetBlue decided to defer deliveries of 24 E190s, from an old delivery range of 2014-2018 to a new range of 2020-2022. Embraer's 3Q13 deliveries and backlog report showed that JetBlue had 25 jets left in the company's backlog. JetBlue had originally placed an order for 100 E190s in June 2003. Since that time, JetBlue has deferred deliveries on this order several times and cancelled orders for 12 aircraft, which left the original gross order figure revised down to 88 jets.

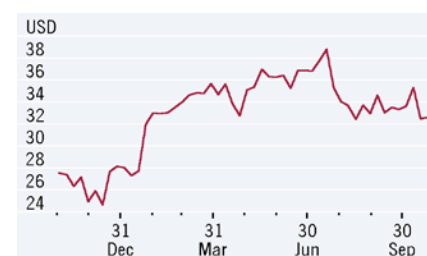
In this morning's release, JetBlue specifically cites that its network growth requirements now call for larger-gauge aircraft. JetBlue also reported that it converted orders for 18 A320s into larger A321s, and separately placed orders for 20 A321 neo's and 15 A321 ceos.

Announcements of large orders create strong, short-term trading gains for the shares of the oem that wins the order. However, unless the oem in question has a large, diverse firm order backlog, the oem's shares have a hard time sustaining such gains. In these instances, oems face the risks of having large portions of their backlog concentrated with just a handful of customers. Aircraft deliveries to such customers threaten the oem's ability to cover fixed production costs because these orders are often associated with large discounts to list prices -- while deliveries spread out over a longer period also reduce operating leverage opportunities. Today's news also shows the difficulty in predicting the pace at which such backlog will eventually convert into revenue. Figure 1 below shows that 72% of Embraer's 3Q13 commercial firm order book is concentrated among just five customers.

(JBLU.O; US\$7.53; Not Rated)

Sell	3
Price (28 Oct 13)	US\$32.79
Target price	US\$32.00
Expected share price return	-2.4%
Expected dividend yield	2.7%
Expected total return	0.3%
Market Cap	US\$5,981M

### Price Performance (RIC: ERJ.N, BB: ERJ US)



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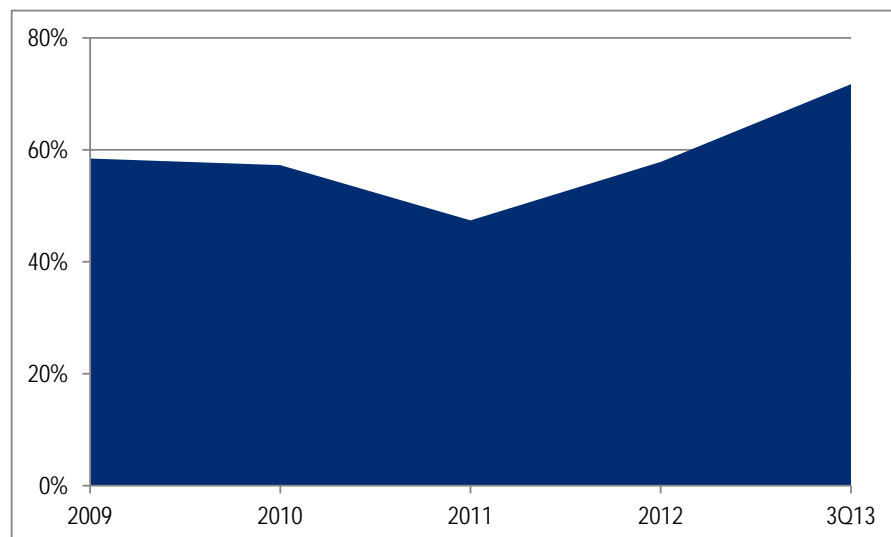
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In contrast to its bigger rivals, Embraer's commercial backlog quality problem has only worsened in recent quarters, following gradual improvements through the end of 2011.

Figure 1. Top five customers' share of Embraer's commercial firm order book



Source: Citi Research

Figure 2. Selected global aerospace comps

Company	Country	Ticker	Rating	Price 10/29/13	Target Price	PE		EV/EBITDA	
						'13E	'14E	'13E	'14E
Embraer	Brazil	ERJ.N	3	\$32.79	\$32.00	28.7x	15.4x	11.1x	9.3x
Boeing	United States	BA.N	1	\$129.88	\$142.00	19.2x	16.3x	33.2x	14.2x
Lockheed Martin	United States	LMT.N	1	\$133.23	\$155.00	13.7x	12.9x	12.4x	11.5x
Raytheon	United States	RTN.N	1	\$81.09	\$97.00	13.9x	12.9x	7.6x	7.8x
Rolls Royce	United Kingdom	RR.L	1	\$18.66	\$20.66	17.2x	15.1x	18.1x	9.0x
Bombardier	Canada	BBD.TO	1	C\$5.26	C\$6.25	13.3x	10.9x	5.2x	14.7x
EADS	France	EAD.PA	1	\$67.09	\$75.81	18.7x	12.8x	25.1x	6.7x
Median						17.2x	12.9x	12.4x	9.3x

Notes: Embraer and Bombardier are covered by Stephen Trent. Rolls Royce and EADS are covered by Devang Doshi. Boeing, Lockheed Martin and Raytheon are covered by Jason Gursky. NR = Not Rated by Citi Investment Research.  
All estimates are calendarized and in USD, except for Bombardier, which are denominated in Canadian Dollars.  
Prices are intra-day levels. 1=Buy, 2=Neutral and 3=Sell. NM = Not Material. NA = Not Available.

Source: Citi Research

## Embraer

### Valuation

For Embraer, we arrive at a target price of US\$32/ADR. This target is based on a forward 8.x – 8.5x EV/EBITDA fair valuation range, reflecting a slight discount to the stock's long-term historical average amidst concerns about reduced backlog quality and increased commercial aero discounting.

### Risks

For Embraer, key risks include lower margins, associated with excessive discounting on commercial jet orders, increased competition in the commercial and business jet segments, and the possibility that both commercial aero and business jet customers migrate toward larger aircraft with longer ranges. Conversely, trading rallies on the back of large order announcements could be more material than we anticipate, or Brazil might increase defense spending, even as the country's primary surplus comes under greater pressure, resulting in our target price being exceeded.

If the impact on the company from any of these factors proves to be greater/less than we anticipate, we believe the stock will likely have difficulty achieving our target price or could outperform it.

## Appendix A-1

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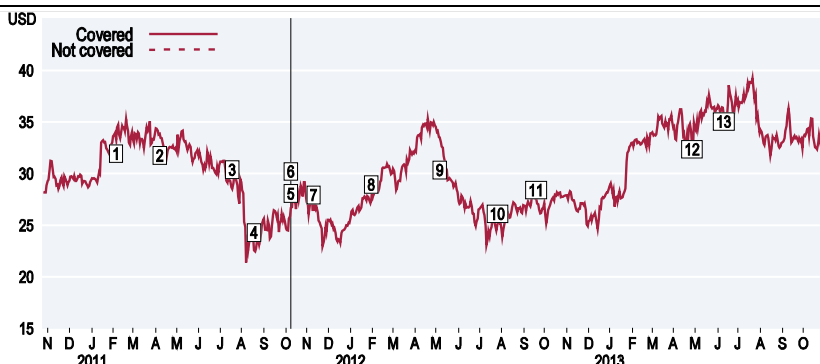
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#### Embraer (ERJ.N)

#### Ratings and Target Price History

#### Fundamental Research

Analyst: Stephen Trent



	Date	Rating	Target Price	Closing Price
1	4-Feb-11	*3S	*37.00	33.28
2	7-Apr-11	3S	*35.00	33.86
3	19-Jul-11	*2S	35.00	28.50
4	18-Aug-11	2S	*29.00	22.56
5	8-Oct-11	Stock rating system changed		

\* Indicates change

	Date	Rating	Target Price	Closing Price
6	8-Oct-11	*1	29.00	25.86
7	10-Nov-11	1	*31.00	26.47
8	31-Jan-12	1	*32.00	27.42
9	7-May-12	*2	*35.00	33.50
10	26-Jul-12	2	*27.00	25.09

	Date	Rating	Target Price	Closing Price
11	19-Sep-12	2	*30.00	27.54
12	26-Apr-13	*3	30.00	32.79
13	11-Jun-13	3	*32.00	35.49

Rating/target price changes above reflect Eastern Standard Time

## Embraer (ERJ.N)

### Ratings and Target Price History

#### Best Ideas Research

#### Relative Call (3 Month)

Analyst: Stephen Trent



	Date	Rating	Target Price	Closing Price
1	19-Apr-11	*ADD LP	-	32.24
2	20-Jun-11	*REM LP	-	31.33
3	8-Sep-11	*ADD LP	-	24.99

\* Indicates change

	Date	Rating	Target Price	Closing Price
4	24-Oct-11	*REM LP	-	28.83
5	21-May-12	*ADD MP	-	29.57
6	3-Jun-12	*REM MP	-	27.31

	Date	Rating	Target Price	Closing Price
7	10-Aug-12	*ADD LP	-	28.11
8	3-Dec-12	*REM LP	-	25.37

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Data current as of 30 Sep 2013

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