25 April 2013 │ 27 pages

Aerospace & Defense (GICS) │ Aerospace & Defense (Citi)
Europe │ France

Safran (SAF.PA)

Turning Bullish on Aftermarket Recovery

- Rating Change
- Target Price Change
- Estimate Change
- Earnings Review

- **Upgrading to Buy** — We view CFM as one of the most attractive aero engine assets in the sector due to its dominant market share on narrow body aircraft and believe that aftermarket recovery should drive a combination of earnings upgrades and a re-rating.
- **Clear Signs of Aftermarket Recovery in 4Q12 & 1Q13** — SAF reported +19% civil aero aftermarket growth in 4Q12A and +10% in 1Q13A against a tough comp, which bodes well for achieving FY13 guidance of "high single digit" growth. Comps get easier in 2Q13 and 3Q13. This is Safran's highest-margin activity.
- **Upside Risk to FY13 Guidance** — Safran raised its FY13 revenue guidance to reflect a strong 1Q13 and the GEPS acquisition but did not raise its EBIT guidance. Given strong aftermarket growth in the quarter, we believe that this is potentially conservative. We forecast +18% EBIT growth in FY13E vs. Safran's guidance of "mid teens" growth.
- **EPS Forecasts Raised by 3-4%** — We now assume +9% civil aftermarket growth (+8% prev.) & include the MRTT acquisition from 2014E. We see upside risk to our estimates in the event of stronger aftermarket recovery or productivity improvements.
- **Excellent Long-Term Growth Prospects** — We forecast 13-14% pa EPS growth through 2015E, driven by high-single-digit revenue growth. Safran's growth outlook looks assured by its dominant position on existing narrow body aircraft and strong market shares to date on the A320NEO and the Chinese COMAC C919.
- **High Barriers to Entry + Good Visibility** — Although quarterly earnings can be volatile, we view the civil aero engine business as inherently attractive on account of its high barriers to entry and good long-term visibility. SAF should have a good idea of the prospective revenue generation from each engine in service over the next 10-15 years.
- **Scope for Further Re-Rating** — We raise our DCF-based Target Price to €43/share (=c15x 2014E P/E) due to higher EPS forecasts, a lower WACC and higher margin and cash flow assumptions. We see scope for Safran to re-rate as aftermarket revenues recover throughout 2013.

Buy	**1**
from Neutral	
Price (24 Apr 13)	€37.00
Target price	€43.00
from €37.00	
Expected share price return	16.2%
Expected dividend yield	2.8%
Expected total return	**19.0%**
Market Cap	€15,428M
	US$20,056M

Price Performance
(RIC: SAF.PA, BB: SAF FP)

Safran (EUR)

Year to 31 Dec	2011A	2012A	2013E	2014E	2015E
Sales (€M)	11,736.0	13,560.0	14,723.2	15,798.4	16,803.6
Net Income (€M)	661.2	1,038.8	1,075.5	1,218.3	1,384.3
Basic EPS (€)	1.62	2.50	2.59	2.93	3.33
Basic EPS (Old) (€)	1.62	2.50	2.52	2.82	3.20
PE (x)	22.9	14.8	14.3	12.6	11.1
EV/EBITDA (x)	10.4	8.9	7.9	6.9	5.9
DPS (€)	0.62	0.96	1.03	1.17	1.33
Net Div Yield (%)	1.7	2.6	2.8	3.2	3.6

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SAF.PA: Fiscal year end 31-Dec — **Price: €37.00; TP: €43.00; Market Cap: €15,430m; Recomm: Buy**

Profit & Loss (€m)	**2011**	**2012**	**2013E**	**2014E**	**2015E**
Sales revenue	11,736	13,560	14,723	15,798	16,804
Cost of sales	-10,021	-11,490	-12,388	-13,253	-14,028
Gross profit	1,715	2,070	2,335	2,546	2,775
Gross Margin (%)	14.6	15.3	15.9	16.1	16.5
EBITDA (Adj)	**1,632**	**1,939**	**2,234**	**2,475**	**2,734**
EBITDA Margin (Adj) (%)	13.9	14.3	15.2	15.7	16.3
Depreciation	-321	-340	-370	-400	-430
Amortisation	-122	-128	-128	-128	-128
EBIT (Adj)	**1,189**	**1,471**	**1,736**	**1,947**	**2,176**
EBIT Margin (Adj) (%)	10.1	10.8	11.8	12.3	13.0
Net interest	-215	-152	-181	-188	-180
Associates	10	19	20	21	22
Non-op/Except	-29	-50	0	0	0
Pre-tax profit	**955**	**1,288**	**1,575**	**1,780**	**2,018**
Tax	-289	-263	-472	-534	-605
Extraord./Min.Int./Pref.div.	-22	-26	-27	-28	-28
Reported net profit	**644**	**999**	**1,076**	**1,218**	**1,384**
Net Margin (%)	5.5	7.4	7.3	7.7	8.2
Core NPAT	661	1,039	1,076	1,218	1,384
Per share data	**2011**	**2012**	**2013E**	**2014E**	**2015E**
Reported EPS (€)	1.59	2.40	2.59	2.93	3.33
Core EPS (€)	1.63	2.50	2.59	2.93	3.33
DPS (€)	0.62	0.96	1.03	1.17	1.33
CFPS (€)	3.08	3.89	5.08	5.29	5.56
FCFPS (€)	1.31	1.36	1.71	2.59	3.08
BVPS (€)	12.14	14.60	16.16	17.92	19.92
Wtd avg ord shares (m)	409	415	415	415	415
Wtd avg diluted shares (m)	405	416	416	416	416
Growth rates	**2011**	**2012**	**2013E**	**2014E**	**2015E**
Sales revenue (%)	9.1	15.5	8.6	7.3	6.4
EBIT (Adj) (%)	35.4	23.7	18.0	12.2	11.8
Core NPAT (%)	26.5	57.1	3.5	13.3	13.6
Core EPS (%)	26.1	52.9	3.5	13.3	13.6
Balance Sheet (€m)	**2011**	**2012**	**2013E**	**2014E**	**2015E**
Cash & cash equiv.	1,431	2,193	1,902	2,550	3,344
Accounts receivables	5,005	5,025	5,175	5,330	5,489
Inventory	3,799	4,131	4,254	4,381	4,512
Net fixed & other tangibles	2,486	2,604	3,456	3,496	3,516
Goodwill & intangibles	6,624	6,950	7,606	8,161	8,617
Financial & other assets	1,357	2,032	2,052	2,073	2,095
Total assets	**20,702**	**22,935**	**24,445**	**25,991**	**27,573**
Accounts payable	8,348	8,767	9,457	10,071	10,610
Short-term debt	998	916	916	916	916
Long-term debt	1,447	2,259	2,259	2,259	2,259
Provisions & other liab	4,787	4,765	4,912	5,085	5,267
Total liabilities	**15,580**	**16,707**	**17,544**	**18,331**	**19,053**
Shareholders' equity	4,968	6,063	6,709	7,441	8,272
Minority interests	154	165	192	219	248
Total equity	**5,122**	**6,228**	**6,901**	**7,660**	**8,520**
Net debt	**1,014**	**982**	**1,273**	**625**	**-169**
Net debt to equity (%)	19.8	15.8	18.4	8.2	-2.0

Valuation ratios	**2011**	**2012**	**2013E**	**2014E**	**2015E**
PE (x)	22.6	14.8	14.3	12.6	11.1
PB (x)	3.0	2.5	2.3	2.1	1.9
EV/EBITDA (x)	10.4	8.9	7.9	6.9	5.9
FCF yield (%)	3.6	3.7	4.6	7.0	8.3
Dividend yield (%)	1.7	2.6	2.8	3.2	3.6
Payout ratio (%)	38	38	40	40	40
ROE (%)	13.6	18.1	16.8	17.2	17.6
Cashflow (€m)	**2011**	**2012**	**2013E**	**2014E**	**2015E**
EBITDA	1,632	1,939	2,234	2,475	2,734
Working capital	47	-85	300	200	100
Other	-432	-237	-421	-474	-520
Operating cashflow	**1,247**	**1,617**	**2,113**	**2,201**	**2,314**
Capex	-715	-1,053	-1,403	-1,124	-1,034
Net acq/disposals	-1,176	-193	-603	0	0
Other	0	0	0	0	0
Investing cashflow	**-1,891**	**-1,246**	**-2,006**	**-1,124**	**-1,034**
Dividends paid	-317	-300	-399	-430	-487
Financing cashflow	**644**	**-368**	**-399**	**-430**	**-487**
Net change in cash	**0**	**3**	**-291**	**648**	**794**
Free cashflow to s/holders	**532**	**564**	**710**	**1,077**	**1,281**
Segment sales (€m)	**2011**	**2012**	**2013E**	**2014E**	**2015E**
Aerospace propulsion	6,110	7,005	7,690	8,335	8,980
Aircraft equipment	3,097	3,691	4,080	4,430	4,700
Defence	1,264	1,315	1,280	1,280	1,280
Security	1,249	1,546	1,670	1,750	1,840
Other/Eliminations	16.0	3.0	3.2	3.4	3.6
Sales - total segments	11,736	13,560	14,723	15,798	16,804
Segment EBIT (€m)	**2011**	**2012**	**2013E**	**2014E**	**2015E**
Aerospace propulsion	909	1,099	1,280	1,430	1,590
Aircraft equipment	202.0	287.0	355.0	412.5	477.3
Defence	58.0	81.0	79.0	79.0	79.0
Security	139.0	145.0	167.0	175.0	184.0
Other/Eliminations	-119.0	-141.0	-145.2	-149.6	-154.1
EBIT - total segments	1,189	1,471	1,736	1,947	2,176
Segment Margin (%)	**2011**	**2012**	**2013E**	**2014E**	**2015E**
Aerospace propulsion	14.9	15.7	16.6	17.2	17.7
Aircraft equipment	6.5	7.8	8.7	9.3	10.2
Defence	4.6	6.2	6.2	6.2	6.2
Security	11.1	9.4	10.0	10.0	10.0
Margin - total segments	10.1	10.8	11.8	12.3	13.0
Leverage & valuation	**2011**	**2012**	**2013E**	**2014E**	**2015E**
Adj. net debt (cash)(£m)	997.0	932.0	1,223.2	575.4	-218.8
Pension deficit (surplus)(£m)	418.0	433.0	433.0	433.0	433.0
Govt. Launch Aid(£m)	682.0	670.0	670.0	670.0	670.0
Adj. ND to EBITDA (x)	0.61	0.48	0.55	0.23	-0.08
Cash conversion (%)	44.7	38.3	40.9	55.3	58.9
Adj. EV/EBITDA (x)	7.6	6.9	7.9	6.8	5.9
Adj. EV/EBIT (x)	10.5	9.1	10.1	8.7	7.4
FCF yield (%)	5.1	4.9	4.6	7.0	8.4

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For definitions of the items in this table, please click here.

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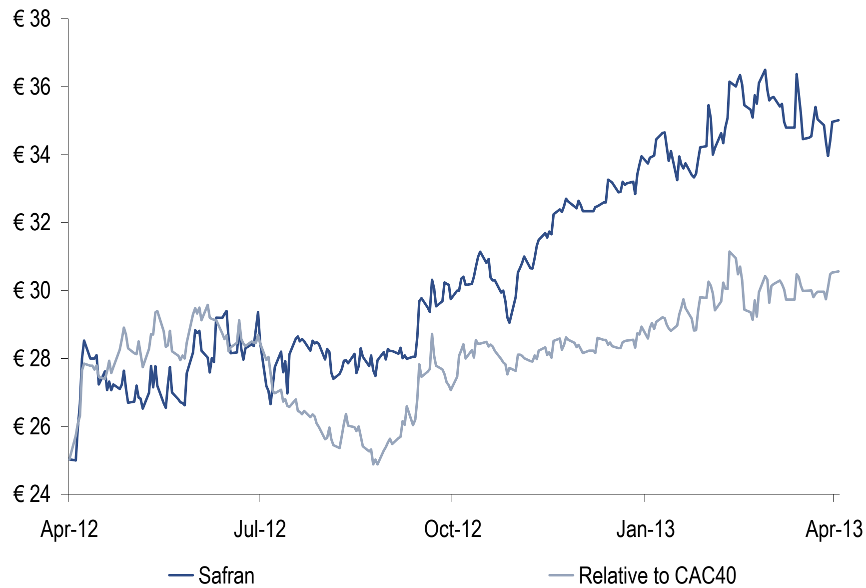
Turning Bullish on Aftermarket Recovery

We upgrade Safran to Buy with a Target Price of €43 (=c15x 2014E P/E).

We upgrade Safran from Neutral to Buy with an updated Target Price of €43 (from €37). Stronger-than-expected 1Q13 revenues and two consecutive quarters of solid civil aero aftermarket growth gives us increased confidence that the long-awaited aftermarket recovery for Safran driven by servicing of second-generation engines is finally happening. This should drive a combination of earnings upgrades and a re-rating from a relatively low headline P/E of 12.6x 2014E.

Figure 1. Safran shares have outperformed the CAC40 modestly since late 2012 following a strong run in 2011.



Source: DataStream

We view Safran's civil aerospace assets, in particular the CFM56, to be amongst the best in the sector and although M&A remains a concern, as does R&D on the LEAP-X, we believe that these risks are more than reflected in the current share price. The next catalyst will be the capital markets event scheduled ahead of the Paris Air Show (16 June), followed by the 1H13 results (26 July) where we see scope for a positive margin surprise and continued civil aero aftermarket growth against easier comps in 2Q12A. Buy.

Upside to FY13 Guidance?

Safran has raised its FY13 revenue guidance from +5% to "high single digit" growth to reflect strong organic revenues in 1Q and the GEPS acquisition.

Safran reported stronger-than-expected 1Q13 revenues of €3.4bn vs. our forecast of €3.2bn and €3.1bn last year. Organic growth in 1Q13 of 9.6% was materially better than our forecast of +4% and also company guidance of +5% for the full year 2013. The main driver of the beat was the core Aerospace Propulsion division, where both OE and Aftermarket growth was ahead of expectations.

Safran has raised its FY13 revenue guidance from +5% to "mid-to-high single-digit" growth vs. €13.56bn in FY12A to reflect strong organic revenue growth in 1Q13 and the acquisition of Goodrich Electrical Power Systems (GEPS), announced in October 2012 and completed in March 2013. Around 1ppt of this guidance increase is accounted for by the inclusion of GEPS, which will contribute c€130m of revenues in FY13. The remainder is organic. Safran's revised revenue guidance implies

€14.2-14.8bn sales (at +5-9% YoY growth) vs. Citi €14.7bn (+9% YoY) and consensus €14.5bn (+7% YoY).

We see upside risk to management's (unchanged) EBIT guidance given strong spares growth in 1Q, productivity improvements and a modest contribution from GEPS.

Despite raising FY13 revenue guidance, Safran's FY13 EBIT guidance remains unchanged, which we view as potentially conservative. Safran continues to guide for a "mid-teens" increase in EBIT in 2013E vs. €1.47bn in 2012A. At 15% growth, this implies EBIT of €1.69bn vs. Citi and consensus €1.74bn. We see upside risk to management guidance as follows:

1. Strong Spares Growth in 1Q — Safran reported +10% civil aero aftermarket growth in 1Q against a relatively tough comparative period in 1Q12A. We therefore see upside risk to Safran's guidance of "high single digit" civil aero aftermarket growth in FY13 as comps get easier throughout the year. We estimate that this high-margin business (>50% EBIT margin) represents as much as 70% of group EBIT and sustained recovery could drive further earnings upgrades throughout the year. See below for more detail.

2. EBIT Contribution from GEPS — Safran guides that GEPS will contribute c€130m of revenues in FY13. Although we believe that this business has a very low margin currently (we assume 4%), it should nonetheless make a positive and growing contribution to EBIT. Our forecasts assume €5m in EBIT rising to €17m in 2015E. The GEPS acquisition increases Safran's exposure to the electrification of aircraft systems, which is an important long-term trend for civil airliners.

3. Cost Cutting / Margin Upside — Safran's guidance of high-single-digit sales growth and 15% EBIT growth in FY13 implies a group EBIT margin of 11.4-11.8% vs. 10.8% in FY12A. This represents c€220m of incremental EBIT on €0.8-1.2bn of incremental sales. However, we calculate that an FX tailwind alone accounts for c€90m of incremental EBIT in 2013E as the hedge rate moves from $1.32/€ to $1.29/€. (FX should continue be a benefit in 2014E and 2015E.) Stripping out FX, this implies an incremental EBIT margin of just 11-16%, which appears low given i) known cost cutting efforts in the Aerospace Equipment division; and ii) operating leverage in the Aerospace Propulsion business.

Safran's FCF guidance remains unchanged at c40% FCF to EBIT conversion (Citi 41%). Although we are cautious about a potential R&D headwind (as discussed later) and the interrelated issue of net capitalised R&D, there is arguably also mechanical upside to Safran's FCF guidance if the EBIT outturn for the year is better than guided.

Civil Aero Aftermarket Recovery…Finally

We believe the aftermarket recovery will drive a combination of EPS upgrades and a re-rating.

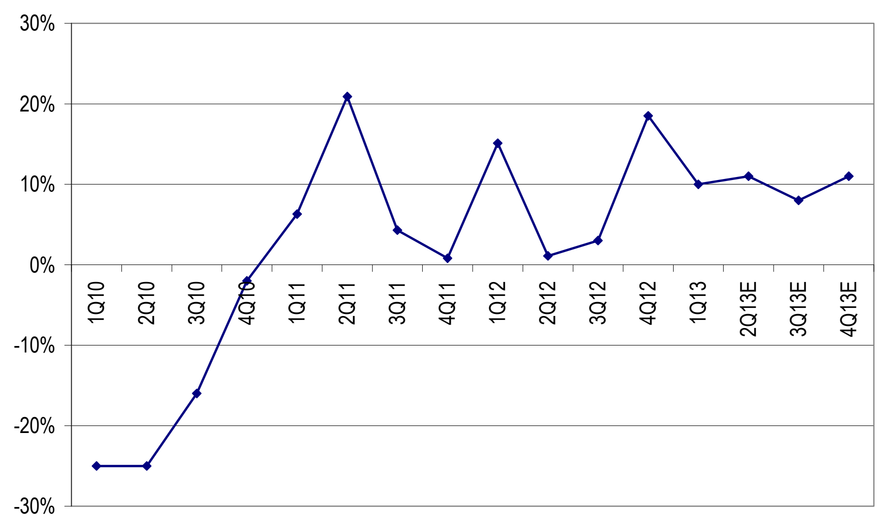
Safran's civil aero aftermarket at last shows signs of recovery, with two consecutive quarters of solid growth driven by servicing of second-generation CFM engines. This should drive a combination of earnings upgrades and a re-rating from a relatively low headline P/E of 12.6x 2014E.

The civil aero aftermarket growth data published within the Aerospace Propulsion division receives a significant amount of attention from the buy and sell side — and for good reason. We estimate that civil aero aftermarket represents just c20% of group sales, but >70% of group EBIT. This reflects the razor / razor-blade business model that is typical in the aero engine industry, where original equipment sales are

made at a very low margin or even a loss and then earn high margins on aftermarket spares sales.

Theoretically aftermarket revenue growth should be relatively easy to forecast, as it is highly correlated to aircraft usage and cannot be deferred indefinitely for regulatory reasons. However, this has not been the case and the aftermarket has been very volatile historically on a quarterly basis. We believe that the aftermarket has been soft for Safran in 2012 for a combination of two reasons: 1) early retirement of older CFM56 engine types and 2) airlines deferring maintenance wherever possible. The bull case for Safran is that whilst the former is unavoidable and inevitable, that the latter could not last forever.

Figure 2. Safran's civil aero aftermarket business has been slow to recover but strong 4Q12 and 1Q13 growth suggests upside risk to FY13's guidance of "high single digit" growth



Source: Company Reports and Citi Research Estimates. Due to a change in disclosure, the above chart shows CFM56 YoY $ growth from 1Q10 to 4Q11 and Civil Aero Aftermarket YoY growth thereafter. The difference between the two is that Civil Aero aftermarket includes high thrust and MRO activities.

Safran reported +19% YoY civil aero aftermarket growth in 4Q12 and +10% in 1Q13E vs. its full year 2013E guidance of "high single digit" growth. We see scope for continued strong momentum in 3Q and 4Q as YoY comparatives get easier.

Safran has now reported 2 consecutive quarters of good civil aero aftermarket growth, which gives us increased confidence that the long-awaited civil aero aftermarket recovery is now happening. We estimate that Civil Aero Aftermarket growth was c19% in 4Q12A following a very soft 2Q and 3Q12 (+1% and +3%, respectively). As shown in Figure 2, the civil aero aftermarket has been extremely volatile on a quarterly basis, which has been an issue for many shareholders — Safran's ability to predict revenues over the next 5 years but inability to forecast the coming quarter has been a source of some frustration, in our view.

Civil Aero Aftermarket growth of +10% in 1Q13A was significantly better than our forecast of +5% and full-year guidance of "high single digit growth". This quarter's result is also very impressive against a tough comp last year (+15% YoY in 1Q12A) and bodes well for Safran achieving and possibly beating its full year guidance (high single digit growth). Safran's aftermarket growth is driven by more modern second-generation CFM engines hitting their first and second service intervals, partly offset by the retirement of older CFM56 engines on Boeing 737 Classic aircraft and also, per the 1Q13 earnings call, on Airbus A340s.

We see scope for Safran to sustain the positive momentum enjoyed in 4Q12A and 1Q13A in the next 2 quarters as year-on-year comparatives get easier. In 2Q12A

Safran reported Civil Aero Aftermarket YoY growth of just +1% and +3% in 3Q12A. Comps do not get tougher until 4Q (+19%). We forecast +9% civil aero aftermarket growth in FY13E (vs. +8% previously), which is at the upper end of company guidance but still lower than the run rate of +10% in 1Q13A. Our earnings forecasts assume 9% civil aero aftermarket growth in FY13E with the Aerospace Propulsion division. If we were to assume 10% civil aero aftermarket growth, our EPS forecasts would also rise by 1% from €2.59 to €2.62 in FY13E. Additionally, we believe that increased market confidence in the resumption of sustained civil aero aftermarket growth would help Safran re-rate from its current P/E of 12.6x 2014E.

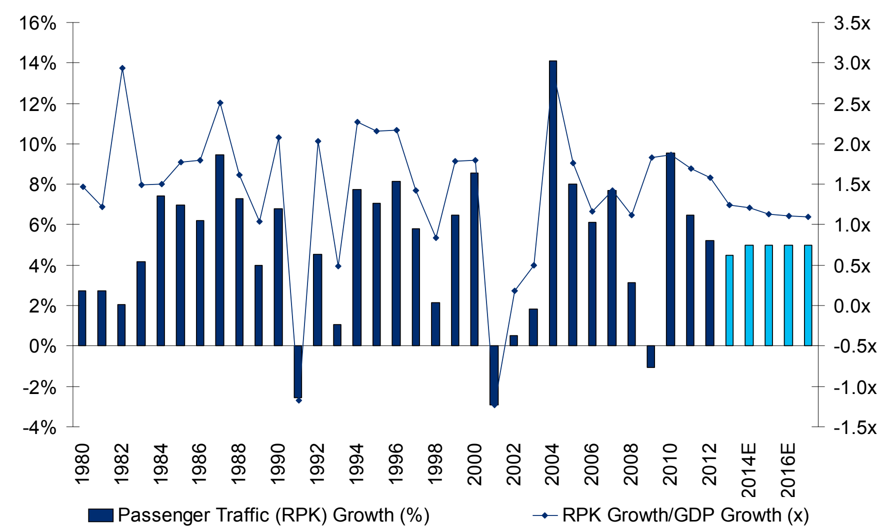
Attractive Long-Term Growth Prospects

We forecast 13-14% pa EPS growth in 2014E and 2015E vs. a current P/E of 12.6x 2014E.

We forecast 13% EPS CAGR on 7% Sales CAGR 2013E-2015E, driven by a combination of organic growth in the core Propulsion and Equipment divisions and margin expansion from 11.8% in 2013E to 13.0% in 2015E. In its November 2012 Investor Meetings presentation, Safran targets €15bn of Sales (6% CAGR 2011A-2015E) and a c15% EBIT margin in 2015E, implying EBIT of c€2.25bn vs. consensus of €2.1bn (a 13.1% margin).

We remain optimistic on Safran's medium to long-term growth prospects for the following reasons:

Figure 3. Passenger Traffic Growth vs. Global GDP Growth (1990-2017E)



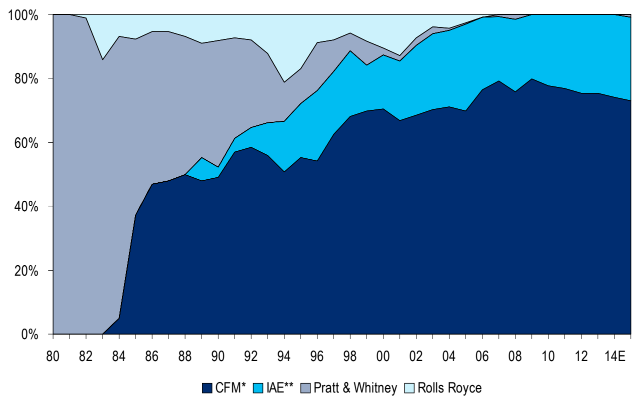
Source: ICAO, IMF. Citi Research Forecasts 2013E-17E

We believe that Safran can achieve high single-digit annual revenue growth in Propulsion and for the group in the medium-term.

- **Positive on Civil Aerospace** — …due to a combination of EM and replacement demand in developed markets and the large order backlog that represents 6-7 years of production. Market focus of late has been on the airframers, notably EADS, where earnings are most obviously leveraged into rising aircraft production rates. However, we view high-single digit growth to be a realistic outlook for the aero engine companies in the medium-term. Passenger traffic growth (RPK) has historically been 1.5-2.0x GDP growth so 4-5% pa passenger traffic growth looks realistic over the medium-term, based on c3% real global GDP growth. In turn this should equate to c4% capacity growth, which should support high-single-digit aftermarket revenue growth assuming modest annual

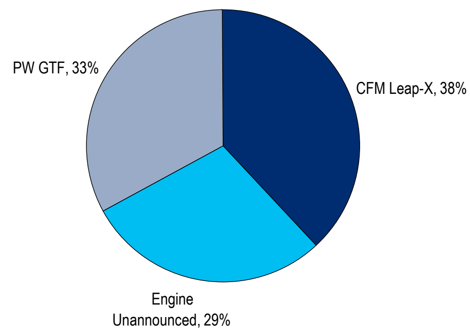
price increase. This is in-line with Safran's medium term aftermarket revenue growth guidance.

Figure 4. Narrow body market share by deliveries 1980A-2015E



Source: Ascend, Citi Research Forecasts (2013E-15E). AE is a JV between Pratt & Whitney, MTU and the Japanese Aero Engine Alliance. CFM is a 50/50 JV between GE and Safran

Figure 5. Airbus A320 NEO Order Backlog by Engine Type



Source: Ascend

Safran's CFM56 engine assets are amongst the most attractive in the industry. CFM's dominance on the next generation of narrow body engines looks set to continue.

- **Dominant Narrow Body Position on Current Generation Aircraft** — Narrow body aircraft account for c70% of large commercial deliveries and c60% of industry revenues. CFM, which is a 50:50 JV between GE and Safran, has a dominant position on current narrow body aircraft and has average c77% market share over the past 5 years (Figure 4). Consequently, the CFM56 is the world's best-selling aero engine of all time, with >20,000 units sold and a sole source position on the Boeing 737NG (i.e. it is the only engine available on that aircraft) and a ~50% market share on the Airbus A320CEO.

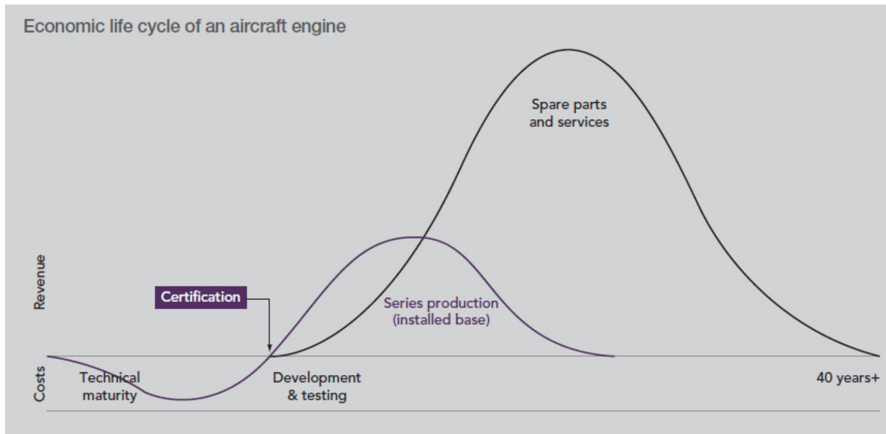
- **Excellent Positioning on Next Generation Programmes** — CFM's dominance of the narrow body market looks set to continue based on market share data of orders so far for the next generation of narrow body aircraft. CFM retains its sole source position on the Boeing 737MAX with the LEAP-X engine. The A320NEO is available with either a CFM LEAP-X unit or a Pratt & Whitney Geared Turbofan. The LEAP-X has a 54% market share on the A320NEO based on aircraft orders where the engine has been selected and the Geared Turbofan 46%. The engine choice is still not confirmed for 29% of the A320NEO backlog.

High Barriers to Entry & Good Visibility

Barriers to entry are high due to significant IP content in a typical aero engine, established relationships with the airframers and airline/lessor customers and the long product cycles that are typical for aerospace products.

The duopolistic nature of the narrow body aero engine market reflects significant technological barriers to entry and established relationships with both the airframers and airline customers. The combination of a long economic life cycle of an engine and the "razor / razor-blade" OE / aftermarket that is typical across the industry also represents another barrier to entry.

Figure 6. The Economic Life Cycle of an Aero Engine



Source: Safran

Figure 6 shows the economic life cycle of an aero engine, which includes a significant period of upfront R&D following by a period of unprofitable OE sales and finally a profitable and relatively stable aftermarket earnings stream. A potential market entrant may need to wait over a decade before generating a positive return on a new engine. The established engine companies also have the advantage of having a number of engines at different stages of their product life cycles, which supports continued investment in new engines.

EM demand for aero engines remains strong, as is the case for other industrial goods and services. However, unlike other industrial sectors, we believe that the near-term threat of competition from new Chinese or EM market entrants looks relatively limited[1]. As part of its latest 5-year plan, China aims to develop its indigenous aerospace industry. However efforts so far have been focused on the COMAC C919, which will compete directly with the A320 and 737, and is scheduled for release by 2016. This will be powered by the GE/Safran CFM LEAP-X engine.

For any given engine that is in service, Safran should have a pretty good idea of its anticipated revenues for the next 10-15 years.

Safran should also enjoy good earnings visibility over the medium-term due to 1) scheduled production rates for Airbus and Boeing through 2015 and 2) visibility over aftermarket revenues, which are determined by fixed maintenance schedules and the replacement of life limited parts based on usage, either flight hours or takeoff/landing cycles. For any given engine that is in service, Safran should have a pretty good idea of its anticipated revenues for the next 10-15 years.

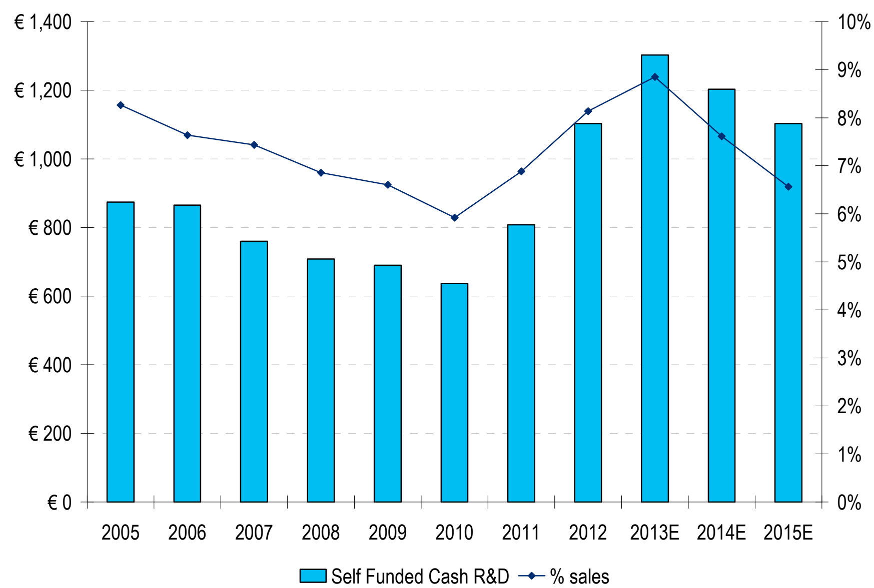
[1] For more details on the Chinese Aerospace industry, see Alex Chang's recent report China Aerospace & Defense - Initiating Coverage: Extensive; Defensive; Exclusive.

2013E should be the peak year for R&D for Safran, with potential improvements in cash conversion and reduced net capitalised R&D thereafter.

R&D Should Peak This Year

We believe that 2013 will be the peak year for R&D for Safran due to investment in the LEAP-X engine, which is due to enter into service in 2016 (Figure 8). This engine will power the next generation of re-engined narrow body aircraft and is likely to remain in service for up to 30 years, based on 10 years of production and 20 years average useful economic life. We forecast self-funded (cash) R&D will rise from €1.1bn in FY12A (8% of sales) to €1.3bn in FY13E (9% of sales) and then fall thereafter. Since 2005 self-funded R&D has averaged c7% of revenues. Falling R&D from 2014E should help boost cash conversion and reduce net capitalised R&D.

Figure 7. Safran Self Funded Cash R&D, 2005-2015E



Source: Company Reports and Citi Research Estimates

There is a risk that the LEAP-X programme proves more challenging than envisaged and that R&D does not peak in 2013. Limited ground clearance on the 737MAX airframe necessitates the use of a smaller diameter engine (the LEAP-1B) with a hotter core, which could potentially also be a challenge. Additionally, whilst the Pratt & Whitney Geared Turbofan uses a step change in technology (the introduction of a gearbox) to achieve a c15% fuel burn improvement, the LEAP-X aims for similar fuel burn improvements through the redevelopment of a highly evolved existing engine design (the CFM56). Figure 8 summarises the forthcoming technical milestones to date on the LEAP-X.

Figure 8. Leap-X: Progress to Date and Upcoming Milestones

Date	Milestones
Jun-05	LEAP56 (Leading Edge Aviation Propulsion) begins
2008	Initial component and rig tests
Jun-09	CFM launches LEAP to power future replacements for current narrow-body aircraft
Nov-09	First LEAP core testing begins
Jul-10	CFM completes eCore demonstrator 1 testing
Nov-10	Launch of the LEAP-1C-powered C919 is announced
Dec-10	LEAP engine is selected to power Airbus A320NEO
Jun-11	Virgin America launches LEAP engine with $1.4 billion order
End-2011	Architecture freeze; Tollgate passed
Late-2012	e-Core 3 test programme started (final tests before start of certification)
2013 (expected)	Engine tests to begin on a 747 flying test bed
2015 (expected)	Engine certification (-1A and -1C)
2016 (expected)	Entry into service (-1C on C919 and -1A on A320 NEO)
2017 (expected)	Entry into service (-1B on B737 MAX)

Source: Company Reports, Citi Research

The next significant milestone for the LEAP-X engine will be flight testing this year and certification in 2015. Pratt & Whitney's competing engine is at a more advanced stage of development. The -1500G version (for Bombardier CSeries) is close to completing certification testing, the -1200G (for the MRJ) has completed its first flight test programme and the -1100G version (for the A320NEO) is in the middle of its full engine testing programme.

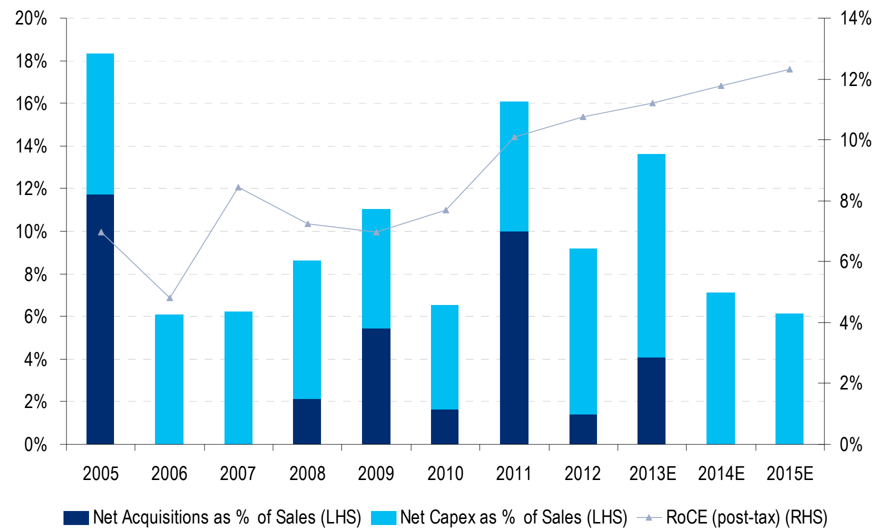
M&A Remains a Concern

MRTT is the latest in a line of acquisitions by Safran.

Alongside the FY12 results, Safran also announced the acquisition of Rolls Royce's 50% share in its RTM322 helicopter engine JV. With a consideration of €293m, this acquisition was relatively small both in the context of Safran's current business (€13.6bn of revenues in 2012A) and past acquisitions including L1 Identity Solutions ($1.5bn, September 2009), GE Homeland Protection ($715m, 2009) and Printrak. This latest bolt-on deal follows Safran's recent acquisition of GEPS for €300m, which was announced in October 2012.

On 23 April Safran announced the acquisition of Rolls Royce's 50% share in its RTM322 helicopter engine JV. This is a business that Safran understands well (as it already owns half of it) and believes that it can develop better through further investments on a standalone basis rather than with Rolls Royce. The acquisition is expected to close by the year end 2013 and will contribute c€85m of revenues and c€30m of EBIT in the first year, with high margins reflecting the fact that a significant proportion of revenues are derived from high-margin aftermarket activities. We have factored this into our earnings forecasts and believe the deal to be c1% accretive from 2014E. Based on the announced €293m cash consideration, the transaction implies 3.4x EV/Sales and 9.8x EV/EBIT.

Figure 9. Safran Acquisitions/Capex as % of Sales vs. ROCE, 2005-15E



Source: Company Reports and Citi Research Estimates

Activist investor TCI publicly criticized Safran's acquisition track record last October.

M&A has been a longstanding concern for investors, which culminated in the public letter written by activist investor The Children's Investment Fund (TCI) published in the FT on 9 October 2012 to CEO Jean Paul Herteman and CFO Ross McInnes where it praised Safran's core business, but criticised CEO Jean Paul Herteman and CFO Ross McInnes' acquisition track record. TCI stated that Safran has a "…history of making bad, value destructive acquisitions and current management has publicly stated that would like to do more deals in the future".

Safran has stated that it believes that the business could support c2x ND/EBITDA on a sustainable basis, and 2.5x ND/EBITDA for a short period if the right opportunity arose. Based on EBITDA of €2.2bn in 2013E and forecast closing Net Debt of €1.2bn in 2013E (after including the GEPS and MRTT acquisitions), we believe that Safran has up to €4.3bn of firepower for further M&A. Theoretically, this could be up to 20% EPS accretive to our base case forecast. We would prefer that Safran did not dilute its investment case through the continued pursuit of M&A and instead considered raising the regular dividend or conducting a buyback.

Earnings Forecasts Raised by 3-4%

We raise our EPS forecasts by 3-4% and believe that re-rating will be the main driver of continued share price outperformance in 2013.

We raise our EPS forecasts by 3-4% to reflect 1) updated revenue guidance; 2) higher 2013E civil aero aftermarket growth forecast; 3) the acquisition of Rolls Royce's 50% stake in the RTM322 helicopter engine JV. Our EPS forecasts are now 1-3% above IBES consensus. Although we do see scope for further positive earnings momentum throughout the year, we believe that re-rating will be the primary driver of outperformance in the next 12 months to reflect an improving civil aftermarket outlook and Safran's strong underlying growth prospects.

Figure 10. Safran – Summary of Earnings Forecasts Changes, 2013E-2015E

	2013E			2014E			2015E		
	New	Old	Diff	New	Old	Diff	New	Old	Diff
Aerospace propulsion	7,690	7,500	3%	8,335	8,050	4%	8,980	8,670	4%
Aircraft equipment	4,080	4,110	-1%	4,430	4,420	0%	4,700	4,680	0%
Defence	1,280	1,280	0%	1,280	1,280	0%	1,280	1,280	0%
Security	1,670	1,660	1%	1,750	1,750	0%	1,840	1,840	0%
Sales	**14,723**	**14,553**	**1%**	**15,798**	**15,503**	**2%**	**16,804**	**16,474**	**2%**
Aerospace propulsion	1,280	1,240	3%	1,430	1,350	6%	1,590	1,500	6%
Aircraft equipment	355	357	0%	413	412	0%	477	477	0%
Defence	79	79	0%	79	79	0%	79	79	0%
Security	167	166	1%	175	175	0%	184	184	0%
Adj. EBIT	**1,736**	**1,696**	**2%**	**1,947**	**1,867**	**4%**	**2,176**	**2,086**	**4%**
Aerospace propulsion	16.6%	16.5%	0.1ppts	17.2%	16.8%	0.4ppts	17.7%	17.3%	0.4ppts
Aircraft equipment	8.7%	8.7%	0.0ppts	9.3%	9.3%	0.0ppts	10.2%	10.2%	0.0ppts
Defence	6.2%	6.2%	0.0ppts	6.2%	6.2%	0.0ppts	6.2%	6.2%	0.0ppts
Security	10.0%	10.0%	0.0ppts	10.0%	10.0%	0.0ppts	10.0%	10.0%	0.0ppts
Adj. EBIT Margin	**11.8%**	**11.7%**	**0.1ppts**	**12.3%**	**12.0%**	**0.3ppts**	**13.0%**	**12.7%**	**0.3ppts**
Exceptionals	0	0	nm	0	0	nm	0	0	nm
Profit from Operations	1,736	1,696	2%	1,947	1,867	4%	2,176	2,086	4%
Net financial income (expense)	-181	-181	0%	-188	-177	6%	-180	-172	5%
Income from associates	20	20	nm	21	21	nm	22	22	nm
Adj. PBT	**1575**	**1535**	**3%**	**1780**	**1711**	**4%**	**2018**	**1936**	**4%**
Income tax expense	-472	-461	3%	-534	-513	4%	-605	-581	4%
rate %	30%	30%	0.0ppts	30%	30%	0.0ppts	30%	30%	0.0ppts
Minority interests	-27	-27	0%	-28	-28	0%	-28	-28	0%
Adj. Net Income	**1,076**	**1,048**	**3%**	**1,218**	**1,170**	**4%**	**1,384**	**1,327**	**4%**
Shares	415	415	0%	415	415	0%	415	415	0%
Adj. EPS (Basic)	**2.59**	**2.52**	**3%**	**2.93**	**2.82**	**4%**	**3.33**	**3.20**	**4%**
DPS	**1.03**	**1.01**	**3%**	**1.17**	**1.13**	**4%**	**1.33**	**1.28**	**4%**
FCF	710	679	5%	1077	753	43%	1281	1037	24%
Net Debt (Cash)	**1223**	**962**	**27%**	**575**	**627**	**-8%**	**-219**	**58**	**-480%**

Source: Company Reports and Citi Research Estimates

Our revised forecasts show +9% YoY sales growth in FY13E (up from +7% previously), which is at the top end of Safran's revised guidance to mid to high single-digit sales growth. We forecast 18% YoY EBIT growth in FY13E (up from +15% previously), ahead of Safran's guidance of mid-teens growth. We believe Safran's FY13 EBIT guidance remains conservative given good recovery in high-margin civil and military aftermarket revenues in 1Q13 and see scope for guidance to be upgraded later in the year.

Following the announcement by Safran of its acquisition of Rolls' 50% stake in their RTM322 engine JV, we now factor in this acquisition in our forecasts from FY14E. We model c€85m incremental revenue and c€30m incremental EBIT contribution from this acquisition in FY14E, in line with Safran's guidance. The relatively high EBIT contribution (vis-à-vis modest incremental revenues) is due to the fact that a majority of the JV revenues are derived from highly profitable aftermarket work. Safran also expects to boost EBIT contribution through potential cost synergies resulting from its full ownership and control of the JV.

Target Price Raised to €43/Share

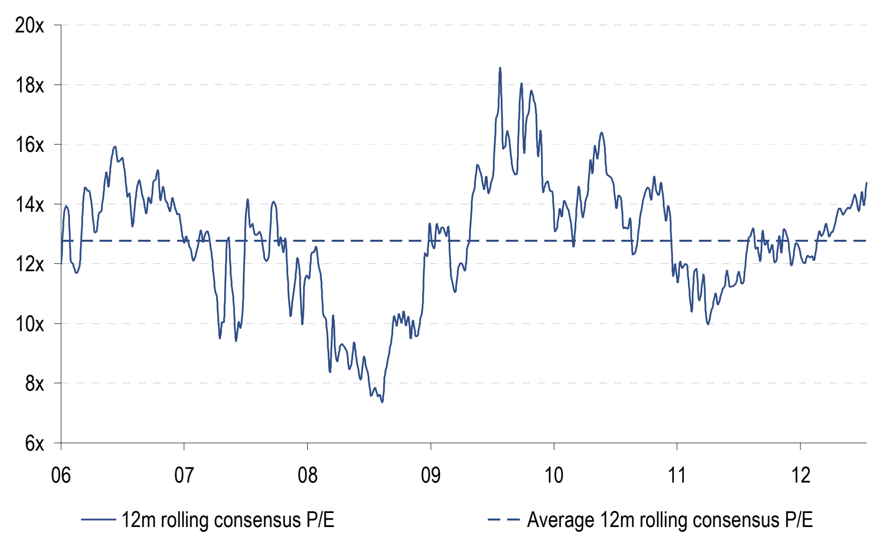
Our revised Target Price of €43/share offers 19% ETR and equates to a 2014E P/E of 14.7x vs. 12.6x currently.

We raise our DCF-based Target Price to €43/share (from €37) to reflect the following: 1) a c4% increase in EBIT forecasts; 2) higher anticipated margins in Aerospace Propulsion driven by slightly faster aftermarket recovery; 3) a lower equity risk premium (0.9x vs. 0.95x previously) to reflect a broader market re-rating and bring Safran's DCF valuation model into line with that of peer Rolls Royce; and 4) the MRTT acquisition. Our 12-month Target Price of €43 represents a 2014E P/E of 14.7x and a 2014E EV/EBIT multiple of 10.6x.

On a headline basis (i.e. without adjusting for net capitalised R&D), we believe that Safran's current valuation looks compelling in comparison to both its own history and the broader industrial sector where earnings risks are arguably more tilted to the downside.

Safran is currently trading on 14.3x 2013E P/E falling to 12.6x in 2014E. This is broadly in line with its historical average of c13x (Figure 11). Our €43/share 1-year Target Price implies a 2014E P/E of 14.7x, which implies that Safran rolls forward its current 2013E P/E rating (14.3x) and re-rates modestly (to 14.7x) over the next 12 months. We forecast 13-14% pa EPS growth in 2014E and 2015E, with upside risk to our estimates in the event strong aftermarket growth, cost cutting or further M&A.

Figure 11. Safran 12m Rolling Forward Consensus P/E: 2006-date



Source: DataStream

Our Target Price implies that Safran should trade at 14.7x 2014E P/E, which is in-line with Rolls Royce's current rating.

Our Target Price implies a 2014E P/E of 14.7x vs. Safran's historical average of c13x, which we believe to be justified given strong EPS growth prospects (13-14% in 2014E and 2015E). Applying Safran's historical peak P/E of 18.5x (from late 2009) to our 2014E EPS forecast would suggest a valuation of approximately €54/share. Safran's current headline P/E of 12.6x 2014E is significantly below its European aero engine peers Rolls Royce (14.7x) and MTU (13.4x) and is broadly in-line with the European Engineers (at c12x 2014E).

Safran currently trades on a 2014E EV/EBIT of 8.7x vs. its historical average of c10.5x. Our €43/share Target Price implies 10.6x 2014E EV/EBIT, at par with its historical average. Historically, Safran's peak EV/EBIT has been close to 13x (mid-2007). Applying peak EV/EBIT of 13x to our 2014E forecasts suggests a valuation of c€57/share. Safran's 2014E EV/EBIT of 8.7x compares favourably to peers Rolls (10.6x) and MTU (10.2x), the broader civil aerospace average (c10x) and the European engineering sector average (c9x).

Net Capitalised R&D

The capitalisation of development costs is an issue that specifically impacts European companies[2] and, in our experience, is the source of significant consternation amongst European investors from both a valuation and theoretical perspective. For more details see our note Accounting for Global Aerospace & Defence: Inconsistencies Distort Global Comps from last August. Net capitalisation of R&D can distort comparative valuations between companies and vs. history and means that earnings in any given year are more reliant on management discretion.

Figure 12. Safran 2014E Valuation vs. Peers: Before & After Expensing Net Capitalised R&D

		2014E P/E		2014E EV/EBIT		EPS Growth
Company	RIC	Pre-Cap R&D	Post-Cap R&D	Pre-Cap R&D	Post-Cap R&D	CAGR 12A-15E
MTU Aero Engines	MTXGn.De	13.2x	17.1x	10.1x	11.3x	9%
Rolls Royce	RR.L	14.5x	14.4x	10.4x	10.3x	13%
Safran	SAF.PA	12.4x	18.1x	9.3x	12.8x	9%

Source: Company Reports and Citi Research Estimates

Cash R&D for Safran is approaching its peak (Figure 7) and because a significant proportion of this relates to the LEAP-X and other new engine programmes, which will remain in service for many years, Safran is capitalising a significant amount of R&D right now. This flatters headline EBIT by c37% in 2013E, based on net capitalised R&D of €636m in 2013E (4.3% of sales) vs. €436m in 2012A (3.2% of sales). Adjusting for net capitalised R&D (i.e. fully expensing R&D costs) means that Safran looks expensive vs. its peers (Figure 12). However, there are some drawbacks with this approach.

We value SAF and the other civil aero stocks using a DCF, which circumvents the problems associated with R&D capitalisation.

R&D represents an investment that should bring benefits over several years. Valuing Safran by applying a mid-cycle P/E or EV/EBIT rating to an earnings number that is depressed by an unusually high R&D spend is punitive and penalizes a company for making long-term investments. We value Safran and the other civil aero stocks using a DCF analysis which, by looking at cash flows instead of earnings, circumvents the problems associated with R&D capitalisation completely.

[2] Under IFRS, all research costs may be expensed by development costs are capitalised if the following criteria can be met: Technical feasibility of completing the asset; Intention to complete the asset; Ability to use or sell the asset; Probable future economic benefits from the asset; Adequate resources to complete development; Ability to measure costs reliably.

Financial Statements

Figure 13. Safran - Income Statement, 2005A-2015E (€ millions)

	2005A	2006A	2007PF	2008PF	2009A	2010A	2011A	2012A	2013E	2014E	2015E
Aerospace propulsion	4,493	5,073	5,917	5,814	5,673	5,604	6,110	7,005	7,690	8,335	8,980
Aircraft equipment	2,510	2,644	2,703	2,775	2,767	2,834	3,097	3,691	4,080	4,430	4,700
Defence/Security	1,231	1,445	1,596	1,676	1,965	2,281	2,513	2,861	2,950	3,030	3,120
Defence	na	na	na	1,021	1,061	1,240	1,264	1,315	1,280	1,280	1,280
Security	na	na	na	655	904	1,041	1,249	1,546	1,670	1,750	1,840
Other/Eliminations	2,342	2,167	6	64	43	41	16	3	3	3	4
Sales	**10,576**	**11,329**	**10,222**	**10,329**	**10,448**	**10,760**	**11,736**	**13,560**	**14,723**	**15,798**	**16,804**
Aerospace propulsion	na	13%	17%	-2%	-2%	-1%	9%	15%	10%	8%	8%
Aircraft equipment	na	5%	2%	3%	0%	2%	9%	19%	11%	9%	6%
Defence/Security	na	17%	10%	5%	17%	16%	10%	14%	3%	3%	3%
Defence	na	na	na	na	4%	17%	2%	4%	-3%	0%	0%
Security	na	na	na	na	38%	15%	20%	24%	8%	5%	5%
Growth	**na**	**7%**	**-10%**	**1%**	**1%**	**3%**	**9%**	**16%**	**9%**	**7%**	**6%**
Organic Sales Growth	**na**	**na**	**na**	**na**	**-3%**	**-1%**	**6%**	**9%**	**7%**	**6%**	**6%**
Aerospace propulsion	456	561	636	594	628	663	909	1,099	1,280	1,430	1,590
Aircraft equipment	212	197	112	62	73	127	202	287	355	413	477
Defence/Security	35	-101	75	67	95	183	197	226	246	254	263
Defence	na	na	na	40	9	55	58	81	79	79	79
Security	na	na	na	27	86	128	139	145	167	175	184
Other/Eliminations	-22	-192	-36	-57	-67	-95	-119	-141	-145	-150	-154
EBIT	**681**	**465**	**787**	**666**	**729**	**878**	**1,189**	**1,471**	**1,736**	**1,947**	**2,176**
EBIT Growth	**na**	**-32%**	**69%**	**-15%**	**9%**	**20%**	**35%**	**24%**	**18%**	**12%**	**12%**
Aerospace propulsion	10.1%	11.1%	10.7%	10.2%	11.1%	11.8%	14.9%	15.7%	16.6%	17.2%	17.7%
Aircraft equipment	8.4%	7.5%	4.1%	2.2%	2.6%	4.5%	6.5%	7.8%	8.7%	9.3%	10.2%
Defence/Security	2.8%	-7.0%	4.7%	4.0%	4.8%	8.0%	7.8%	7.9%	8.3%	8.4%	8.4%
Defence	na	na	na	3.9%	0.8%	4.4%	4.6%	6.2%	6.2%	6.2%	6.2%
Security	na	na	na	4.1%	9.5%	12.3%	11.1%	9.4%	10.0%	10.0%	10.0%
Margin	**6.4%**	**4.1%**	**7.7%**	**6.4%**	**7.0%**	**8.2%**	**10.1%**	**10.8%**	**11.8%**	**12.3%**	**13.0%**
Exceptional Items	18	0	0	146	-35	-13	-29	-50	0	0	0
Borrowing Costs	-41	-22	-10	-19	-38	-36	-42	-54	-65	-72	-64
Other Finance Costs / Income	-46	-56	-44	-135	-136	-132	-173	-98	-116	-116	-116
Net Finance Costs	**-87**	**-78**	**-54**	**-154**	**-174**	**-168**	**-215**	**-152**	**-181**	**-188**	**-180**
Income from associates	3	4	4	10	3	9	10	19	20	21	22
PBT	615	391	737	668	523	706	955	1,288	1,575	1,780	2,018
Clean PBT	**597**	**391**	**737**	**522**	**558**	**719**	**984**	**1,338**	**1,575**	**1,780**	**2,018**
Income Tax	-164	-199	-219	-123	-108	-173	-289	-263	-472	-534	-605
Effective Tax Rate	27%	51%	30%	18%	21%	25%	30%	20%	30%	30%	30%
Discontinued Operations	0	0	-97	-233	-4	-5	3	0	0	0	0
Minorities	-7	-15	-15	-15	-16	-20	-25	-26	-27	-28	-28
Net Income	**444**	**177**	**406**	**297**	**395**	**508**	**644**	**999**	**1,076**	**1,218**	**1,384**
Clean Net Income	**431**	**177**	**503**	**411**	**427**	**523**	**661**	**1,039**	**1,076**	**1,218**	**1,384**
Average Shares	409	410	411	405	399	400	409	415	415	415	415
Average Diluted Shares	409	411	411	405	401	404	405	416	416	416	416
EPS	**€ 1.08**	**€ 0.43**	**€ 0.99**	**€ 0.73**	**€ 0.99**	**€ 1.27**	**€ 1.57**	**€ 2.41**	**€ 2.59**	**€ 2.93**	**€ 3.33**
Clean EPS	**€ 1.05**	**€ 0.43**	**€ 1.22**	**€ 1.01**	**€ 1.07**	**€ 1.31**	**€ 1.62**	**€ 2.50**	**€ 2.59**	**€ 2.93**	**€ 3.33**
growth	na	-59%	na	na	5%	22%	23%	55%	4%	13%	14%
Clean Diluted EPS	€ 1.05	€ 0.43	€ 1.22	€ 1.01	€ 1.06	€ 1.30	€ 1.63	€ 2.50	€ 2.59	€ 2.93	€ 3.33
DPS	**€ 0.36**	**€ 0.22**	**€ 0.40**	**€ 0.25**	**€ 0.38**	**€ 0.50**	**€ 0.62**	**€ 0.96**	**€ 1.03**	**€ 1.17**	**€ 1.33**
Payout Ratio	33%	51%	40%	34%	38%	39%	39%	40%	40%	40%	40%

Source: Company Reports and Citi Research Estimates

Figure 14. Safran - Cash Flow Statement, 2005-2015E (€ millions)

	2005A	2006A	2007PF	2008PF	2009A	2010A	2011A	2012A	2013E	2014E	2015E
EBIT	681	465	787	666	729	878	1,189	1,471	1,736	1,947	2,176
Depreciation & amortisation	395	419	350	396	395	404	443	468	498	528	558
Cash Tax	-119	-202	-212	-257	-73	-103	-148	-198	-356	-402	-456
Net Interest	-41	-22	-10	-19	-38	-36	-42	-54	-65	-72	-64
Change in working capital	252	-149	-133	-216	361	317	47	-85	300	200	100
Other	158	343	336	150	29	-1	-242	15	0	0	0
Operating cash flow	**1,326**	**854**	**1,118**	**720**	**1,403**	**1,459**	**1,247**	**1,617**	**2,113**	**2,201**	**2,314**
Tangible Capex	-308	-346	-384	-441	-293	-271	-352	-419	-619	-440	-450
Intangible Capex	-391	-343	-252	-230	-292	-254	-363	-634	-784	-684	-584
Free cash flow	**627**	**165**	**482**	**49**	**818**	**934**	**532**	**564**	**710**	**1,077**	**1,281**
Cash conversion	92%	35%	61%	7%	112%	106%	45%	38%	41%	55%	59%
Acquisitions/disposals	-1,241	0	0	-221	-569	-175	-1,176	-193	-603	0	0
Equity issued	0	8	19	-151	6	6	180	118	0	0	0
Dividends paid	-95	-154	-90	-202	-73	-161	-317	-300	-399	-430	-487
FX/Other	-103	35	-161	59	-45	-82	-240	-124	0	0	0
Net cash flow	**-812**	**54**	**250**	**-466**	**137**	**522**	**-1,021**	**65**	**-291**	**648**	**794**
Net Debt (cash) b/f	-339	473	419	169	635	498	-24	997	932	1,223	575
Net Debt (cash) c/f	**473**	**419**	**169**	**635**	**498**	**-24**	**997**	**932**	**1,223**	**575**	**-219**

Source: Company Reports and Citi Research Estimates

Discounted Cash Flow

Figure 15. Safran - Discounted Cash Flow (€ millions)

	2013E	2014E	2015E	2016E	2017E	2018E	TV
Aerospace propulsion	7,690	8,335	8,980	9,610	10,280	11,000	11,330
Aircraft equipment	4,080	4,430	4,700	5,030	5,380	5,760	5,933
Defence	1,280	1,280	1,280	1,280	1,280	1,280	1,280
Security	1,670	1,750	1,840	1,930	2,030	2,130	2,162
Other/Eliminations	3	3	4	4	4	4	4
Sales	**14,723**	**15,798**	**16,804**	**17,854**	**18,974**	**20,174**	**20,708**
Aerospace propulsion	10%	8%	8%	7%	7%	5%	3%
Aircraft equipment	11%	9%	6%	7%	7%	5%	3%
Defence	-3%	0%	0%	0%	0%	0%	0%
Security	8%	5%	5%	5%	5%	3%	2%
growth	**9%**	**7%**	**6%**	**6%**	**6%**	**6%**	**3%**
Aerospace propulsion	1,280	1,430	1,590	1,634	1,748	1,870	1,869
Aircraft equipment	355	413	477	528	565	605	623
Defence	79	79	79	90	90	90	77
Security	167	175	184	193	203	213	216
Other/Eliminations	-145	-150	-154	-162	-172	-184	-184
EBIT	**1,736**	**1,947**	**2,176**	**2,283**	**2,433**	**2,594**	**2,601**
Aerospace propulsion	16.6%	17.2%	17.7%	17.0%	17.0%	17.0%	16.5%
Aircraft equipment	8.7%	9.3%	10.2%	10.5%	10.5%	10.5%	10.5%
Defence	6.2%	6.2%	6.2%	6.0%	6.0%	6.0%	6.0%
Security	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%
EBIT Margin	**11.8%**	**12.3%**	**13.0%**	**12.8%**	**12.8%**	**12.9%**	**12.6%**
Taxation	-521	-584	-653	-685	-730	-778	-780
NOPAT	**1,215**	**1,363**	**1,523**	**1,598**	**1,703**	**1,816**	**1,821**
Capital Expenditure	-1,403	-1,124	-1,034	-1,034	-1,034	-1,034	-750
% of Sales	9.5%	7.1%	6.2%	5.8%	5.4%	5.4%	3.6%
Depreciation	498	528	558	616	655	696	715
% of Sales	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%
Capex/Depreciation	2.8x	2.1x	1.9x	1.7x	1.6x	1.5x	1.1x
Change in Working Capital	300	200	100	0	0	0	0
% of Sales	2.0%	1.3%	0.6%	0.0%	0.0%	0.0%	0.0%
Free Cash Flow	**610**	**967**	**1,148**	**1,181**	**1,324**	**1,478**	**1,785**
Enterprise Value	**20,957**	**€ 50.50**					
Net Debt	-1,535	-€ 3.70					
Launch Aid	-670	-€ 1.60					
Pension Deficit	-433	-€ 1.00					
Associates	-281	-€ 0.70					
Minority Interests	-165	-€ 0.40					
Equity Value	**17,873**	**€ 43.00**					

Source: Company Reports and Citi Research Estimates

Safran

Company description

Safran has three divisions split between 82% civil and 18% military related activities. The Aerospace Propulsion division (52% of 2011 sales) designs and manufactures engines for civil and military aircraft, including the CFM56, the world's best selling civil aero engine (via a 50:50 JV with GE). The Aircraft Equipment division (26% of 2011 sales) supplies civil and military markets with equipment for planes and helicopters including wheels, brakes, landing gear and wiring. The Defence & Security business (22% of 2011 sales) focuses on electronic systems for the defence market, such as avionics, optronic systems, Unmanned Aerial Vehicles and security systems such as biometric testing and secure payment terminals.

Investment strategy

We rate Safran Buy. We believe the company offers attractive earnings growth prospects driven by a combination of recovering civil aftermarket, productivity improvements, cost savings and FX tailwinds. We forecast 13-14% pa EPS growth through 2015E, driven by high single-digit revenue growth. Safran’s growth outlook looks assured by its dominant position on existing narrow body aircraft and strong market shares to date on the A320NEO and the Chinese COMAC C919. We view CFM as one of the most attractive aero engine assets in the sector due to its dominant market share on narrow body aircraft and believe that aftermarket recovery should drive a combination of earnings upgrades and a re-rating.

Valuation

Our DCF-based one-year target price of €43/share (rounded) assumes c9% WACC and c3% terminal growth rate. Our target price equates to a 2014E EV/EBIT of 10.6x (vs. a historical average of c10.5x) and a 2014E P/E of 14.7x (vs. historical average of c13x). 2013E EV/Sales implied at our target price is 1.3x vs. a 2013E EBIT margin of 12.3%, rising to 13.0% in 2014E.

Risks

The key risks to our investment thesis on Safran are: 1) The recovery in civil aero aftermarket may prove short-lived. CFM56 aftermarket growth may disappoint driven by newer engines staying on the wings longer than expected and / or airline operators continuing to defer engine shop visits. An increased cannibalization of older CFM engines to provide spare parts for newer engines may also weigh on Safran's civil aero growth prospects. 2) The civil aerospace cycle may enter into a downturn resulting in significant deferrals/cancellation of existing orders and retirement of engines in the current fleet as airlines cut capacity. Safran may face increased vendor financing demands amidst a potential downturn which could negatively impact its cash flows. 3) Potential margin improvement in Aircraft Equipment business may prove difficult to achieve. 4) Self-funded R&D may stay at a high level driven by potential development challenges on new engines such as the Leap-X. 5) Aircraft development programmes with significant Safran exposure such as re-engined 737 and A320, 787, A350 and A400M may suffer further material development delays. 6) A significant decline in the value of $ vs. the € may negatively affect Safran's civil aerospace business given predominantly $-denominated revenues and €-denominated costs.

If the impact of these risk factors is more or less negative than we currently anticipate, then the share price could fail to reach or exceed our target price.

MTU Aero Engines (MTXGn.DE; €72.44; 2)

Valuation

Our DCF-derived one-year target price of €75/share is based on a c9% WACC and a 2.7% terminal growth rate. Our TP implies a 2014E EV/EBIT of c10.5x (vs. an historical average of c9x) and a 2014E P/E of 13x (vs. an historical average of c12x). We believe a premium valuation vs. history is justified given MTU's attractive top-line growth prospects due to its positions on fast-growing aircraft platforms, which underpin a sizeable aftermarket opportunity. 2014E EV/Sales implied at our TP is 1.17x (vs. a 2014E EBIT margin of c11%).

Risks

The key risks to our investment thesis on MTU are: (1) Defence budget cuts, especially in Germany; (2) MTU is a RRSP (Risk and Reward Sharing Partner) on a number programmes that have suffered delays (e.g. 787, A380, A400M) where further delays could have a financial impact; (3) MTU has material transactional FX exposure to the US dollar (it is a beneficiary of a strong $ vs. the €). (4) High oil prices could result in older aircraft being retired earlier, impacting MTU’s aftermarket revenues. (5) Earnings could potentially be depressed due to pricing pressure on the PW1000G (on which MTU has a 15% stake) as Pratt & Whitney tries to establish its position as the lead engine supplier on the A320NEO.

If any of these risk factors has a greater downside impact than we anticipate, the share price will likely have difficulty attaining our target price. Conversely, if the impact of any of these upside risks is greater than we anticipate, the stock could exceed our target price.

Rolls Royce (RR.L; £11.33; 1)

Valuation

Our DCF-based 1,200p target price assumes a 9.4% WACC and a 2.6% terminal growth rate. Our target price equates to 11.7x 2014E EV/EBIT and 15.5x 2014E P/E, vs. RR's historical averages of c10x and c11x, respectively, reflecting our view of the company's strong earnings growth prospects driven by margin improvements, higher returns, reduced cyclicality and a much stronger balance sheet than in the past. The implied EV/Sales at our target price is 1.46x 2014E (vs. our long-run margin assumption of 13.3%).

Risks

The key risks to our investment thesis on Rolls Royce are: (1) a cyclical downturn in civil aerospace, especially potential production rate cuts and retirements of existing engines in the fleet; (2) widely anticipated margin and cash flow improvements are not as great as expected or are achieved later than expected; (3) weakness in the commercial Marine business; (4) defence budget cuts, particularly in the US; (5) Energy margins remain stubbornly low; (6) R&D expenditure remains at an elevated level; (7) transactional foreign exchange risk; (8) the risk of investigation by the SFO

following passing on of files re alleged bribery and corruption in overseas markets; (9) defence margins could contract from a very high level in 2012E; (10) execution problems with new programmes (e.g. 787, A350XWB, A380, A400M, G650).If any of these risk factors has a greater downside impact than we anticipate, the share price will likely have difficulty attaining our target price.

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

Rolls Royce (RR.L)

Ratings and Target Price History
Fundamental Research

Analyst: Jeremy Bragg

	Date	Rating	Target Price	Closing Price
1	11-Aug-10	2M	*5.81	5.26
2	1-Nov-10	2M	*5.87	6.30
3	21-Dec-10	*1M	*7.32	6.26
4	10-Feb-11	1M	*7.41	6.26
5	26-Apr-11	1M	*7.53	6.23
6	17-May-11	1M	*7.23	6.20
7	7-Sep-11	1M	*7.14	6.25
8	7-Oct-11	Stock rating system changed		
9	7-Oct-11	*1	7.14	5.96
10	17-Oct-11	1	*7.82	6.74
11	28-Oct-11	1	*7.90	7.09
12	20-Dec-11	1	*8.09	7.10
13	7-Feb-12	1	*8.29	7.76
14	14-Feb-12	1	*8.59	7.69
15	26-Apr-12	1	*8.70	8.32
16	3-May-12	1	*9.70	8.59
17	12-Jul-12	1	*9.80	8.62
18	8-Oct-12	1	*10.00	8.79
19	20-Dec-12	1	*10.70	8.83
20	21-Feb-13	1	*12.00	10.32

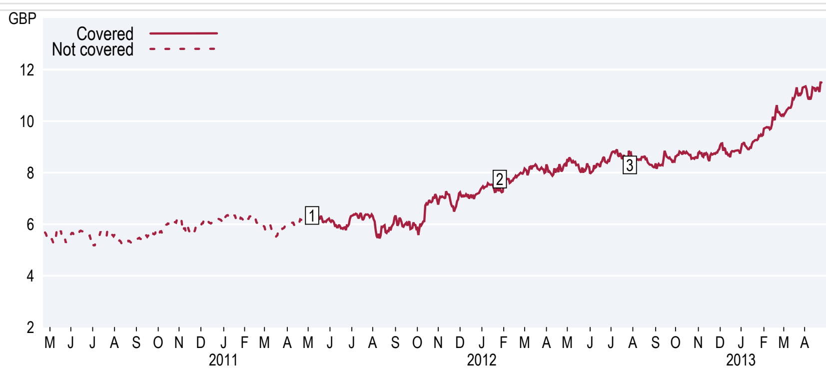
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Rolls Royce (RR.L)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Jeremy Bragg



	Date	Rating	Target Price	Closing Price
1	6-May-11	*ADD MP	-	6.17
2	26-Jan-12	*REM MP	-	7.42
3	27-Jul-12	*ADD MP	-	8.76

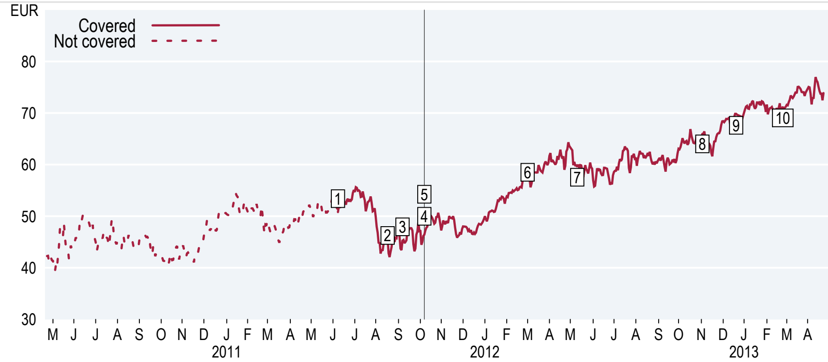
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

MTU Aero Engines (MTXGn.DE)

Ratings and Target Price History
Fundamental Research

Analyst: Jeremy Bragg
Covered since June 9 2011



No.	Date	Rating	Target Price	Closing Price
1	8-Jun-11	*1M	*65.00	50.80
2	17-Aug-11	1M	*60.00	45.69
3	7-Sep-11	1M	*55.00	45.25
4	7-Oct-11	Stock rating system changed		
5	7-Oct-11	*1	55.00	46.41
6	1-Mar-12	*2	*58.00	57.44
7	10-May-12	2	*62.00	59.58
8	2-Nov-12	2	*66.00	65.95
9	20-Dec-12	2	*73.00	69.85
10	25-Feb-13	2	*75.00	71.22

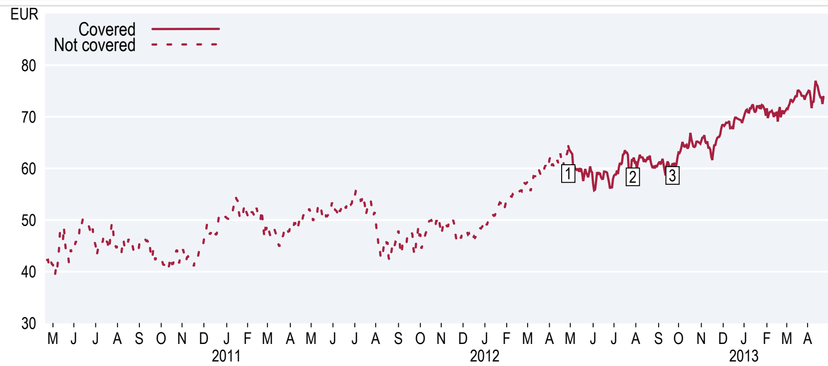
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

MTU Aero Engines (MTXGn.DE)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Jeremy Bragg
Covered since June 9 2011



No.	Date	Rating	Target Price	Closing Price
1	27-Apr-12	*ADD LP	-	64.33
2	27-Jul-12	*REM LP	-	61.60
3	21-Sep-12	*ADD LP	-	60.96

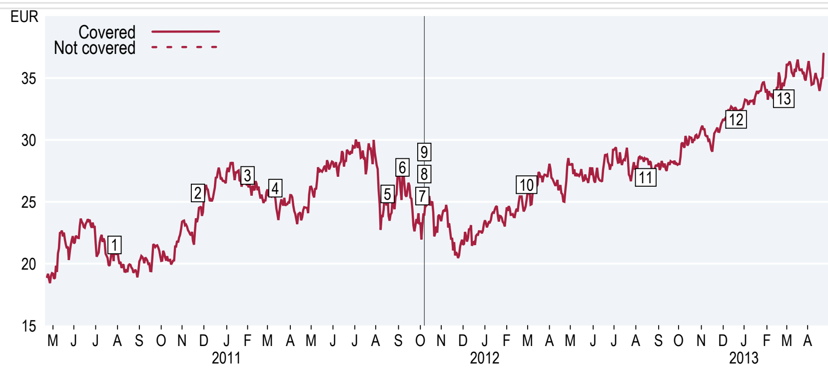
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Safran (SAF.PA)

Ratings and Target Price History
Fundamental Research

Analyst: Jeremy Bragg

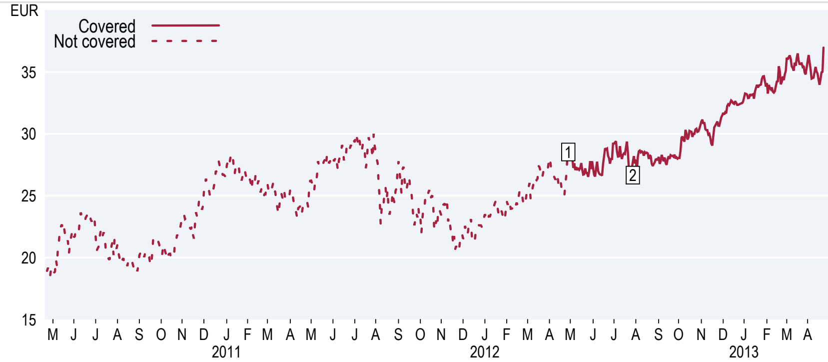


No.	Date	Rating	Target Price	Closing Price
1	28-Jul-10	2H	*24.00	21.51
2	23-Nov-10	2H	*25.00	23.70
3	1-Feb-11	2H	*26.50	26.43
4	11-Mar-11	2H	*26.70	25.24
5	17-Aug-11	2H	*29.00	25.45
6	7-Sep-11	2H	*27.00	27.13
7	5-Oct-11	2H	*24.00	23.08
8	7-Oct-11	Stock rating system changed		
9	7-Oct-11	*2	24.00	23.96
10	29-Feb-12	*1	*30.00	25.16
11	15-Aug-12	1	*32.00	28.44
12	20-Dec-12	*2	*36.00	32.52
13	26-Feb-13	2	*37.00	34.34

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Safran (SAF.PA)
Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)
Analyst: Jeremy Bragg



	Date	Rating	Target Price	Closing Price
1	27-Apr-12	*ADD MP	-	28.53

	Date	Rating	Target Price	Closing Price
2	27-Jul-12	*REM MP	-	27.75

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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	12 Month Rating			***Relative Rating***		
Data current as of 31 Mar 2013	**Buy**	**Hold**	**Sell**	**Buy**	**Hold**	**Sell**
Citi Research Global Fundamental Coverage	48%	39%	12%	7%	87%	7%
% of companies in each rating category that are investment banking clients	53%	49%	43%	65%	49%	51%

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Risk rating takes into account both price volatility and fundamental criteria. Stocks will either have no risk rating or a High risk rating assigned.
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considered non-relative-rated (NRR). For purposes of NASD/NYSE ratings-distribution-disclosure rules we correspond NRR to Hold in our ratings distribution table for our 3-month relative rating system. However, we reiterate that we do not consider NRR to be a recommendation.

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Investment ratings are determined by the ranges described above at the time of initiation of coverage, a change in investment and/or risk rating, or a change in target price (subject to limited management discretion). At other times, the expected total returns may fall outside of these ranges because of market price movements and/or other short-term volatility or trading patterns. Such interim deviations from specified ranges will be permitted but will become subject to review by Research Management. Your decision to buy or sell a security should be based upon your personal investment objectives and should be made only after evaluating the stock's expected performance and risk.

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Citigroup Global Markets Ltd	Jeremy Bragg
Citigroup Global Markets India Private Limited	Devang Doshi
Citigroup Global Markets Inc	Jason Gursky; Deane M. Dray, CFA; Stephen Trent

OTHER DISCLOSURES

The subject company's share price set out on the front page of this Product is quoted as at 24 April 2013 01:38 PM on the issuer's primary market.

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