

Equities

30 January 2012 | 10 pages

Embraer (ERJ)

Cleared For Higher Altitudes

- Company Update
- Target Price Change
- Estimate Change

- **Target price bumps up to \$32/ADR** — with stable- to (slightly rising) 2012 commercial jet deliveries, we see a combination of stronger defense revenue, continued solid expense discipline and Citi's expectations for a stronger dollar as providing Embraer's shares with upside over the next several months. As we increase our estimates, our 12M target price rises by US\$1 (now US\$32/ADR). We remain buyers of Embraer.
- **Defense, then biz jets look brightest** — page 2 of our Eye In The Sky piece, dated 1/26/12, identified these two segments as being very important drivers of the company's future growth. *We see Embraer's defense growth as an area that's still somewhat overlooked by the market* – as commercial aero competition grows more intense, we believe that the Brazilian government sees Embraer as a vital partner, as the country boosts its defense industry. Moreover, a new product pipeline, together with a gradually improving cycle, should also support medium-term biz jet growth.
- **.. but watching Honda** — Bloomberg news reported that auto maker Honda plans to launch its (long-delayed) Honda jet, positioned against Embraer's Phenom's and rival Cessna's very light business jets. We concur with CIRA US aerospace analysts Jason Gursky and Jon Raviv that the lowest end of the biz jet market looks very difficult (please see Jason's note, dated 10/11/11). To this end, we would note that Embraer's Legacy 500 and 450 product launches target the (bigger) mid-sized jet category.
- **Higher estimates** — we incorporate 4Q11 jet deliveries (82 vs. 65 previously), and we nudge our annual EJet deliveries higher (taking tot. deliveries from 217 this year, 268 next and 289 in 2014, to 221, 272 and 293, respectively). We also materially softened our expectations for (non-cash) charges, below the operating line (f/x, transaction charges, minority interest, etc.). However, *for 2012, we are conservatively estimating US\$150M in charges, related to AMR*. Sales mix, together with our incorporation of Citi's expectations for a weaker end-2012 real (from R\$1.70 to R\$1.80/\$) also boost our EBITDA estimates.

Buy	1
Price (30 Jan 12)	US\$26.94
Target price	US\$32.00
	from US\$31.00
Expected share price return	18.8%
Expected dividend yield	3.0%
Expected total return	21.8%
Market Cap	US\$4,874M

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



Estimates	2010A	2011E	2012E	2013E	Q111A	Q211A	Q311A	Q411E
Sales (US\$M)	5,364	5,921	6,193	6,520	1,056	1,359	1,364	2,143
EBITDA adj (US\$M)	611	762	774	785	156	153	188	264
EBITDA margin adj (%)	11.4	12.9	12.5	12.0	14.8	11.3	13.8	12.3
Net income (US\$M)	330	337	267	440	105	96	2	134
EPS (US\$)	1.82	1.87	1.47	2.43	0.58	0.53	0.01	0.74

Valuation	Ratios				2010A	2011E
EV/EBITDA adj	7.7	6.3	6.1	5.8	ROE adj (%)	11.3
PE	14.8	14.4	18.3	11.1	ROIC adj (%)	8.2
FCF (%)	15.5	3.1	8.2	7.5	Debt to Capital (%)	37.8
						40.7

Source: Company Reports and dataCentral, Citi Investment Research & Analysis.

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Fiscal year end 31-Dec	2009	2010	2011E	2012E	2013E
Valuation Ratios					
P/E adjusted (x)	10.5	14.8	14.4	18.3	11.1
EV/EBITDA adjusted (x)	7.4	7.7	6.3	6.1	5.8
P/BV (x)	1.7	1.6	1.5	1.5	1.4
Dividend yield (%)	0.0	3.3	3.7	3.0	5.0
Per Share Data (US\$)					
EPS adjusted	2.57	1.82	1.87	1.47	2.43
EPS reported	2.57	1.82	1.87	1.47	2.43
BVPS	15.44	16.74	17.73	18.39	19.49
DPS	0.00	0.89	1.01	0.81	1.34
Profit & Loss (US\$m)					
Net sales	5,498	5,364	5,921	6,193	6,520
Operating expenses	-5,118	-4,972	-5,378	-5,638	-5,955
EBIT	379	392	543	555	566
Net interest expense	10	18	9	0	21
Non-operating/exceptionals	-69	-1	27	1	0
Pre-tax profit	321	408	579	556	587
Tax	158	-63	-236	-139	-147
Extraord./Min.Int./Pref.div.	-14	-15	-6	-150	0
Reported net income	465	330	337	267	440
Adjusted earnings	465	330	337	267	440
Adjusted EBITDA	609	611	762	774	785
Growth Rates (%)					
Sales	-13.2	-2.4	10.4	4.6	5.3
EBIT adjusted	-29.3	3.2	38.6	2.2	2.0
EBITDA adjusted	0.2	0.3	24.8	1.5	1.4
EPS adjusted	20.2	-29.0	2.3	-21.0	65.1
Cash Flow (US\$m)					
Operating cash flow	346	905	483	561	523
Depreciation/amortization	229	219	219	219	219
Net working capital	-233	-364	-52	-74	-136
Investing cash flow	-185	-139	-325	-160	-160
Capital expenditure	-185	-150	-330	-160	-160
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	334	-1,888	-38	-147	-242
Borrowings	216	-661	371	0	0
Dividends paid	0	-162	-182	-147	-242
Change in cash	496	-1,122	120	254	121
Balance Sheet (US\$m)					
Total assets	8,890	8,391	9,336	9,654	9,908
Cash & cash equivalent	2,546	1,393	1,711	1,965	2,086
Accounts receivable	407	349	762	828	867
Net fixed assets	1,101	1,201	1,351	1,292	1,232
Total liabilities	6,007	5,260	6,017	6,066	6,122
Accounts payable	596	750	1,004	1,053	1,109
Total Debt	2,566	1,905	2,276	2,276	2,276
Shareholders' funds	2,883	3,132	3,319	3,588	3,786
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	11.1	11.4	12.9	12.5	12.0
ROE adjusted	18.6	11.3	10.8	8.2	12.9
ROIC adjusted	15.7	8.2	7.4	10.0	9.9
Net debt to equity	0.7	16.3	17.0	8.7	5.0
Total debt to capital	47.1	37.8	40.7	38.8	37.5

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Figure 1. ERJ Estimate Changes (US\$ MM, except per share data)

	4Q11E	2012E	2013E	2014E
Revenue New	2,142.9	6,192.6	6,520.4	6,884.6
Revenue Old	1,862.6	6,049.1	6,378.3	6,743.9
% Change	15.0%	2.4%	2.2%	2.1%
EBITDA New	264.3	773.8	784.9	828.7
EBITDA Old	213.1	728.2	737.0	778.0
% Change	24.0%	6.3%	6.5%	6.5%
EPADS New	0.74	1.47	2.43	2.67
EPADS Old	0.31	0.97	1.02	1.14
% Change	141.7%	52.7%	139.2%	134.4%

Source: Citi Investment Research and Analysis

Figure 2. Selected Global Aerospace Comps

Company	Country	Ticker	Rating	Price 01/30/12	Target Price	PE		EV/EBITDA	
						'11E	'12E	'11E	'12E
Embraer	Brazil	ERJ.N	I	\$26.94	\$32.00	14.5x	18.4x	7.2x	6.7x
Boeing	United States	BA.N	I	\$73.76	\$87.00	13.9x	16.2x	10.0x	10.3x
Lockheed Martin	United States	LMT.N	I	\$81.94	\$92.00	10.5x	10.5x	9.9x	9.8x
Raytheon	United States	RTN.N	I	\$47.74	\$59.00	9.0x	9.4x	5.3x	5.5x
Rolls Royce	United Kingdom	RR.L	I	\$11.53	\$12.90	15.8x	12.7x	9.0x	7.5x
Bombardier	Canada	BBDb.TO	I	C\$4.42	C\$7.70	12.8x	9.5x	5.1x	5.2x
EADS	France	EAD.PA	I	\$33.57	\$41.00	23.6x	13.9x	4.2x	3.1x
Median						13.9x	12.7x	6.5x	6.3x

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

Source: Citi Investment Research and Analysis

Embraer

Company description

Embraer is a manufacturer of commercial jets up to 110 seats with almost 40 years of experience in designing, developing, manufacturing, selling and providing after sales support to aircraft for the Commercial Aviation, Executive Aviation, and Defense and Government segments. With headquarters in São José dos Campos, State of São Paulo, the Company has offices and customer service bases in the United States, France, Portugal, China and Singapore. Embraer is among Brazil's leading exporting companies, and currently has a firm order backlog of US\$15.8B.

Investment strategy

Buy-rated Embraer is one of the leading regional jet manufacturers and the only one that (currently) produces (mid-sized) 100-seat commercial jets. On one level, we recognize Embraer as a global leader in the space, owing to its very high product quality and its solid management. On another front, however, we cannot ignore growing competitive threats (Sukhoi's SSJ is due to be certified in 2011, the CSeries in 2013, etc.). We are also concerned that the company's potential move to produce a clean-sheet commercial jet could eventually come into service, just as the aerospace cycle has peaked. On the flipside, we also recognize that Brazil's Rousseff administration seems keen to support this company (and we could eventually see more modest growth in the company's defense business). Finally, we recognize that the stock's recent pull-back (since our first upgrade in late July 2011) has arguably resulted in better value now, versus what had previously been the case.

Valuation

For Embraer, we arrive at a target of US\$32/ADR. We arrive at this target using a blend of 8x 2012E EV/EBITDA (80% weight) and 0.4x EV/firm order backlog range (20%).

Looking at Embraer's (post 9/11) historical EV/EBITDA, and we would note that the stock has traded at an historical average of 9.2x, and contrasts with a maximum of 14.5x and a minimum of 2.7x (includes the 2H08-1Q09 "crisis" period). However, investors should note that the vast history of the above numbers reflected Embraer's (US GAAP-based) forward multiples at the time. Therefore, an 8x EV/EBITDA multiple now probably reflects (what should be) an IFRS equivalent of the stock's long-term historical average. We see this level as generous, as we believe that the company's (relatively lower-beta) defense segment ops, could be more than offset by competitive headwinds in commercial and corporate aero.

Our 0.4x multiple is below our (long-term) fair value range (0.5x to 0.65x) – that fair value range is slightly above historical (US GAAP) averages, and versus a low of 0.1x and a high of 0.78x. Although Embraer's backlog quality has generally improved (vs. a decade ago), we also now worry more about the stability of portions (including JetBlue and FlyBe, as well as Phenom customers). Therefore, we believe that our 0.4x multiple (a rough, IFRS-equivalent of the historical average) is reasonable.

Our EV/EBITDA multiple valuation gets us to a price of US\$32/ADR, while EV/backlog (somewhat coincidentally) also get us to US\$32/ADR.

Risks

In our opinion, the market is more focused on Embraer's long-term operating prospects. However, we continue to believe that Embraer faces several near-term risks, including the potential for deferrals (or cancellations) of aircraft deliveries from its economically weak customers and/or from commercial aero customers that have (arguably) ordered aircraft at the behest of politicians (China, etc.), rather than orders placed by the internal (economic) needs of that customer.

Although recovering, jet financing continues to be weak, and the question remains: when could we see recoveries in credit availability and in loan-to-value ratios?

Over the medium-term, EJets face competition headwind from Bombardier's CSeries, Sukhoi Superjets and other products. Similarly, we could see pressure on narrow-body business jets due to lower EU/US economic growth, high global inventory levels and competitor product launches (such as Cessna's Citation M2).

If the negative impact of any of these factors turns out to be more significant than we anticipated, Embraer could have difficulty reaching our target price.

On the upside, Embraer could receive a large order unexpectedly. Brazil's currency could also decline (against the US dollar), potentially allowing for greater-than-expected margin expansion.

Appendix A-1

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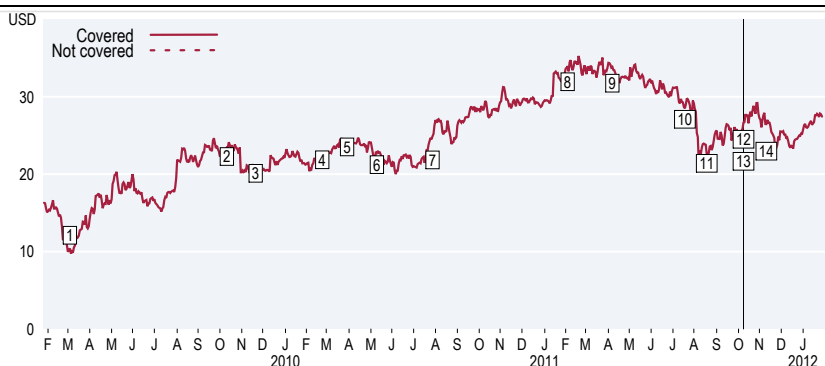
IMPORTANT DISCLOSURES

Embraer (ERJ.N)

Ratings and Target Price History

Fundamental Research

Analyst: Stephen Trent



	Date	Rating	Target Price	Closing Price
1	4-Mar-09	1S	*35.00	10.40
2	12-Oct-09	1S	*33.00	23.47
3	20-Nov-09	*2S	*27.00	20.49
4	23-Feb-10	2S	*26.00	22.01
5	30-Mar-10	2S	*29.00	24.03

* Indicates change

	Date	Rating	Target Price	Closing Price
6	11-May-10	2S	*27.00	22.75
7	28-Jul-10	2S	*31.00	24.90
8	3-Feb-11	*3S	*37.00	33.94
9	7-Apr-11	3S	*35.00	33.86
10	19-Jul-11	*2S	35.00	28.50

	Date	Rating	Target Price	Closing Price
11	18-Aug-11	2S	*29.00	22.56
12	8-Oct-11	Stock rating system changed		
13	8-Oct-11	*1	29.00	25.86
14	10-Nov-11	1	*31.00	26.47

Rating/target price changes above reflect Eastern Standard Time

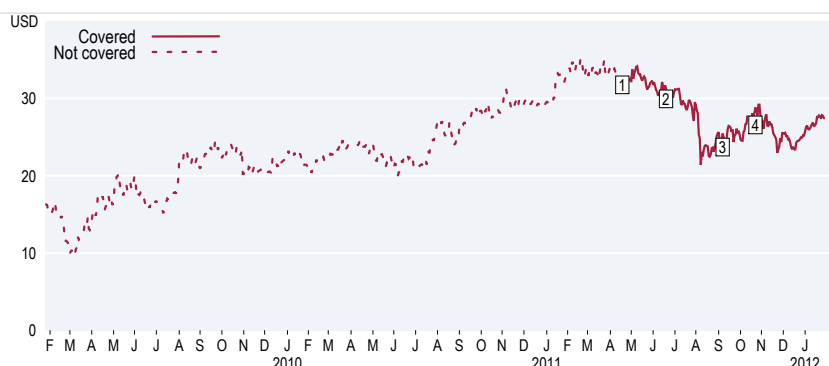
Embraer (ERJ.N)

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

* Indicates change

	Date	Rating	Target Price	Closing Price
3	7-Sep-11	*ADD LP	-	25.46
4	24-Oct-11	*REM LP	-	28.83

Rating/target price changes above reflect Eastern Standard Time

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Data current as of 31 Dec 2011

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