



EMBRAER STOCK PLUNGES 12% ON EARNINGS: 3 THINGS INVESTORS MISSED

News / Finance



Shares of Brazilian aircraft manufacturer Embraer plummeted 12% on Thursday, after the company's Q4 earnings and 2016 guidance missed expectations. This cut its market cap to less than \$5 billion.

Embraer's defense business was under pressure throughout 2015 as the Brazilian government has been coping with a budget crisis. Its executive jet business has also fallen on hard times, due to a glut of used aircraft that has hurt demand and driven down profit margins. Finally, the weak Brazilian real hasn't provided as much of a profit tailwind as bulls -- myself included -- had hoped.

Nevertheless, Embraer's Q4 earnings report isn't as bad as it appears. Here are three key pieces of good news that investors seem to be overlooking.

Commercial jet deliveries rising

First, Embraer projected that it will deliver 105 to 110 commercial jets in 2016, up from 101 last year. At the midpoint of the guidance range, this would be the highest number of deliveries since

2009.

Embraer's next-generation commercial jets will begin arriving in 2018. Image source: Embraer.

This is particularly remarkable because Embraer will begin the transition to its next-generation commercial jet line in 2018. Aircraft manufacturers frequently have to cut back on production around this point in an aircraft type's life cycle. Instead, Embraer is ramping up growth.

As of Dec. 31, Embraer had a record year-end order backlog of \$22.5 billion, of which 70% relates to the commercial aviation segment. It also appears to be close to sewing up a 30-aircraft order from Alaska Air for E175 regional jets and a 50-airplane deal with Iran. This would further bolster Embraer's order book and help it fill the last handful of production slots for current-generation E-Jets.

If Embraer can perform this well with its main product nearing the end of its production run, it should be able to deliver even faster growth as production of its E2-series jets fully ramps up around 2020.

Strong commercial jet margins

Of course, higher sales and production of commercial jets wouldn't be very helpful if Embraer wasn't making much money on those sales. Indeed, weak commercial aircraft pricing has been a concern at Embraer for the past year or so. However, the commercial aviation segment didn't cause Embraer's margin deterioration in 2015.

In fact, the 2015 commercial aviation segment margin was 13.4%, excluding the special charge related to Republic Airways' recent bankruptcy filing. That compares to a segment margin of just 9.5% in 2014.

Embraer's commercial aviation segment is posting strong profitability. Image source: Embraer.

Embraer's strong margin improvement came despite continued deterioration in the commercial aviation product mix. The smaller, lower-margin E170 and E175 jets accounted for 83% of deliveries in 2015. This margin expansion shows that Embraer's commercial aviation segment really is benefiting from the weak Brazilian real.

Cash flow outperformance

Finally, Embraer generated strong cash flow last year: especially in Q4. The company projected throughout 2015 that free cash flow could be slightly negative. However, it ultimately produced \$178 million in free cash flow for the full year.

The decline of the real helped here, too (along with increased customer deposits associated with Embraer's strong order activity). Embraer underspent its investment budget by \$132 million -- roughly 20% -- as the weak real reduced its personnel costs in dollar terms.

Strong cash flow will allow Embraer to complete the development and production ramp of the next-gen E2 jets without needing to issue more debt or stock. Longer-term, higher free cash flow will give Embraer the opportunity to reward patient shareholders with dividend increases or share buybacks.

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