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The Boeing Co. (BA)

Cowen & Co. Aerospace/Defense Conference
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Analyst, Cowen & Company

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MANAGEMENT DISCUSSION SECTION

Cai Von Rumohr
Analyst, Cowen & Company

We would like to move ahead. Delighted to have with us next The Boeing Company, and from Boeing, the CFO and Executive VP, Greg Smith. Greg, welcome.

Gregory D. Smith

Hey, Cai, thank you, and good morning, everybody.

Cai Von Rumohr
Analyst, Cowen & Company

Thank you for being here.
QUESTION AND ANSWER SECTION

Cai Von Rumohr
Analyst, Cowen & Company

So demand from China has been more muted in the last year, especially for next-gen aircraft. What sort of potential is there for additional orders and given the potential tensions [indiscernible] (00:00:29) North Korea, how should we think about all of that?

Gregory D. Smith

Yeah. Look, demand from China has been very good. Over the last five years, I think we've booked over 600 orders there. So, it's pretty significant. And as you look forward, it's going to continue to be a big marketplace for us and many others. And again, look at the growth in the middle class, by 2025 that will outpace the total population of the United States. As we were talking earlier, you look at the fundamentals around traffic and also the pent-up demand in commercial travel for folks. You've got 130 million people and less than 10% have a passport. So if you look at those fundamentals of what's really going to drive traffic near term and long term, we think there's significant opportunity. If you look over the next 20 years, about 7,200 aircraft are going to be required there. And so it really gets go, Cai, your presence in country, your engagement and collaboration with our customers and then do you have the right products and services in place to address this growing market. And certainly with that, we need to support global trade and it impacts our business significantly and in our workforce and our economy. So, it's important to us, but it's been very robust, and I think it'll continue to be robust again. Those fundamentals are critical to passenger growth going forward.

Cai Von Rumohr
Analyst, Cowen & Company

Got it. So, maybe you can update us on the status of the 777 bridge and the 777X entry into service.

Gregory D. Smith

Sure. Yeah, I mean, 777 bridge, we made some good progress there. We booked about 40 orders last year and the team has done a great job. As you know, it's a terrific product bringing significant value to our customers, and we've been very active in filling that bridge. So, still some work to do, but doing a good job. 2018 is the transition year into 777X. So we've got the lead airplane in the factory. We were just out there last week touring the production and watching the wing lay-up there and the rearrangement of the factory and the capital that's getting put in place. So, this will be a big year for us as we bring that 777 into the production environment of [ph] that BCA (00:03:06).

So, we're also at the same time, Cai, obviously focused on 777X orders through that period, out in 2020 and beyond. So, team's got the right focus, again done a nice job on the bridge, a little bit more work to do, and 777X is off to a good start.
So, what should we think about the fact though somewhat over 7%, 8% of the X backlog is from the big three Mid-East customers, one of them just [ph] re-opt (00:03:36) for some more A380s. What's the contingency in case some of these guys defer or cancel?

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**Gregory D. Smith**  

Yeah. Well, certainly, we haven't seen any indication of that. Again, those are big 777 operators. So, they're moving up into the 777X. And I think, again, you got to look at the fundamentals around traffic and the value proposition that the airplanes bring into the market. And that value proposition is very strong for our customers. So obviously that region of the world continues to be a watch for us and ensuring that we can fulfill our commitments at the same time that our backlog is holding firm on the 777X, and up to now it is. But again, I think the fundamentals of getting into really what's happening in the region, the trends in air traffic, at the same time that value proposition the airplane's bringing in, so the backlog is holding firm.

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**Cai Von Rumohr**  
Analyst, Cowen & Company

So it'd look like that's a plane that would be well-suited to Asia Pacific.

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**Gregory D. Smith**  

Yes.

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**Cai Von Rumohr**  
Analyst, Cowen & Company

Are there any customers there that are thinking about...

[indiscernible] (00:04:42)

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**Gregory D. Smith**  

Yeah. No, it's a great question. There's an active pipeline of customers that are interested in the 777X. And again, it just comes back to what's that aircraft bringing into the marketplace versus the competition or what they're currently operating. And it's a significant value proposition. So we've got a good list of active customers. And we've got the team focused on filling up that skyline.

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**Cai Von Rumohr**  
Analyst, Cowen & Company

Okay. So if we look at the 747 and the 767 freighters, I mean, I think at one point I felt like there's no way the 747 was going to survive.

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**Gregory D. Smith**  

Right.
And yet you just got this nice order from UPS who are having super traffic, or cargo growth.

Gregory D. Smith  

Yeah.

Cai Von Rumohr  
Analyst, Cowen & Company

What's the outlook for getting some more and could the rate move up from six per year?

Gregory D. Smith  

Yeah. I mean, there's definitely more demand for freight and we're seeing that on the 747 as you indicated with the UPS order, but we're also seeing it on 777, as well as the 767. So there's been a nice rebound there. As we talked about many times, we've got an incredible product offering when it comes to freight. And there's no one else that can match that product offering. So, we're in a good place I think as far as what we offer in the market, and the fundamentals are improving. So, we're expecting to see more demand there going forward. And I think as you look at the projections from them and from third parties, we're still continuing to see more cargo traffic and at the same time, replacement of aged aircraft. And so, I think there's some more opportunity there. So, we're in the right place to address that market.

Cai Von Rumohr  
Analyst, Cowen & Company

Do you see the tax act as having any impact on aircraft demand?

Gregory D. Smith  

No. I mean, obviously tax reform at the highest level we think is critical for our economy here, and we are very pleased to see that be brought to finalization. And I think everybody will benefit that competitively. This is really about competing on a global scale. But I don't see a changing pattern of – particularly the buying patterns, but it will definitely give us an opportunity to invest more in our people, more in our technology, more in capital. And R&D, as we talked about on the earnings call, it's going to make us more competitive and that's – at the end of the day, this is what it's all about. This is about being competitive on a global scale and tax reform helps us do that.

Cai Von Rumohr  
Analyst, Cowen & Company

Right. So, 737 MAX, looks like it's off to a great start. Any key remaining challenges as you ramp that program?

Gregory D. Smith  

Yeah. I mean, look, last year was a big year, right? We're going up in rate and we're bringing the MAX into the line. And the plans put in place that were really put in place probably 18 to 24 months out about how do you do that, work with the supply chain on the detailed schedule of what's needed when and how do you minimize the disruption in the factory as you're bringing that product in while going up in rate on the NG. So setting up that separate line and de-risking and bringing that implementation in was absolutely key, and the team did a great job.
executing that. We delivered 74 MAX aircraft last year combined with going up in rate. And this year, it will be – 40% to 45% of our 737 deliveries will be MAX. So right now, of the three lines, two have MAX aircraft in the line, so we're ramping up quick here.

I'd say, Cai, the normal puts and takes as you're going up in rate and bringing new airplane in place, but we're meeting all our commitments on our deliveries. And we'll continue to again, I'll say, take off the efficiencies of last year and introduce more MAX airplanes in the line this year. The team's done a great job.

And how about the 777X, is it on schedule, ahead of schedule, what are the milestones we should look for?

Yeah. Well, like I said, this is a big year for us. This is where we production-harden the design. And so, as I mentioned, we were out last week, Dennis and I, doing a program review with the team and walk in the factory and talking to the folks building, in particular, the wing, and it's going well. I mean, there's certainly always challenges, but they're manageable from what the team has described to us and as we've looked at it, but I'd say the normal transition that's taking place there and a lot of de-risking. Remember, we set up a lot of labs, just lessons learned, a lot of labs and investments upfront to de-risk the production system. And so as you go out and look at that wing today, you can see the benefit of that de-risking.

So, that's going to continue as we move that airplane through the line. But again, we made a lot of those investments purposefully to try to bring the risk profile and allow the introduction of the X to be smooth. That's coming off of the lessons learned of the 787 and frankly some lessons learned off of the MAX aircraft as well, so team's off to a good start, but big year for us.

And so commercial productivity, how is it doing on the 787? And how should we think about the profile of deferred cost amortization with the 787-10 coming and are we going to see a flattened period or how should we think about that?

Team is doing a great job, Cai. We just wide – swapped that line last week as well listening to the accomplishments of last year, but frankly team more focused on what they're going to do in 2018, and they've done a great job. I think I mentioned in one of the earnings calls, they implemented some practices that are now becoming best practices that we're bringing across to F-18, F-15 on to Chinook and so on around productivity in this, what we call, champion time mindset where – what's our best performance on what aircraft, how do we get that best performance and then how do we make that more predictable on the next unit. So, you're seeing it. You saw it in 2017's performance, in particular, on cash. Team is doing a good job, lot still left to do, but really coming down the curve nicely. Charleston and Seattle and the lessons learned between the two and sharing back and forth and optimizing the line in common production system and commonality around productivity improvements and enhancements, but they've got this, I'll say, champion mindset that is all about unit
cost and efficiency and how we’re leveraging the One Boeing advantage, so things that are on Chinook that are viewed as a best practice, how do we get those on to 787. That collaboration is happening more than it ever has.

Cai Von Rumohr
Analyst, Cowen & Company

Yeah.

Gregory D. Smith

So like I said, not done, more work to be done, but the team had a great 2017, and I think they’ve got great plans in place for 2018. And think about – we’ve got now the 747-8, the 787-9 and the 787-10 all in flow and were implemented – the 787-9 and 787-10 really flawlessly and meeting the commitments to the customers, delivering the airplanes on time and getting them into the hands of our customers on a day-to-day basis, and the team has done a great job.

Cai Von Rumohr
Analyst, Cowen & Company

If we look at last year, it looks like every single quarter you've made nice progress if you account for the block change. So, as we look at this year, should it be kind of linear that every quarter is nice or...

Gregory D. Smith

Yeah.

Cai Von Rumohr
Analyst, Cowen & Company

...do we have the 787-10 coming in and that could be flatter or how should we think about the...

Gregory D. Smith

Yeah. I mean, look, you’re going to see improvement, but you’re right. I mean, you add the block changes in and then combined with mix of the 787-10, when you look on a pure deferred, you're not going to see, I'll say, the perfect curve there. But when you look at unit cost, you will. You'll see it, you'll see it there. So, there's some puts and takes, but overall, that profile is going to improve in 2018.

And again, they're focused on unit-by-unit improvement, whether it's through supply chain negotiations or factory, it's all about efficiency and flow. How do you reduce the flow? And again, they've reduced the flow by double digits both Seattle and in Charleston. So they've got the right mindset and they've got good momentum and good ideas in the pipeline about how to continue to improve that, which ultimately will impact deferred.

Cai Von Rumohr
Analyst, Cowen & Company

Right. And so in the middle of the market plane, where are you in your deliberations? What are the milestones before you commit to build it or not?
Gregory D. Smith  

Yeah. I think as we said on the earnings call, we're in active discussions with about 50 customers really describing, I'll say, the full product offering, understanding their needs, the value proposition the airplane would bring to the market, their pricing expectations, potential entries into service dates and things like that. So, I'd say, we're at the normal part of the process in having that discussion, at the same time, working very hard on, I'll say, more finite design around elements of the aircraft producibility that ultimately will get to the business case.

And I think as we said on the call that everything has got to work, it's got to work for the customer, the price needs to be the right price, the value proposition and the - ultimately the cost and the non-recurring and the recurring, all need to come together and meet the requirements that we've put in place. And if they do, we'll make a decision at that point, if they don't, well, obviously we'll make a decision as well. So, I think it's progressing well. We've got a great team in place, but we haven't made the decision yet. So, we're continuing to have that dialogue.

Cai Von Rumohr  
Analyst, Cowen & Company

Is the long pole in the tent choosing an engine, and if so, are you looking at one engine or would you like to have it dual-sourced?

Gregory D. Smith  

Yeah. I mean, just like any development program, that's a critical element. It's not the only critical element. Certainly, producibility and risk profile around recurring and non-recurring, thinking through life cycle opportunities as well on the aircraft, not just on the platform itself. So, there's a number of, I'll say, big pieces in here, Cai, that we're focused on, engines certainly being one of them. So, we've got a great team in place led by Mark Jenks. And if you remember, Mark led the 787, so amongst the many other assignments he's had. So he's had a lot of experience and he's bringing that experience to the program to go through this evaluation and really help us decide whether we'll move forward with it or not.

Cai Von Rumohr  
Analyst, Cowen & Company

So, when could you have an engine decision, because clearly you have to that before (indiscernible)...

Gregory D. Smith  

Yeah. Well, look, you're looking potentially at a 2024, 2025 entry into service. So if you kind of back up from that, I'll give you kind of a good sense of where...

Cai Von Rumohr  
Analyst, Cowen & Company

Right now.

Gregory D. Smith  

Maybe, yeah. I mean, like I said, there's a lot of things that need to – would need to be just decided in the next year or so, and that being one of them.
Cai Von Rumohr
Analyst, Cowen & Company

Got it. Got it.

Gregory D. Smith

Yeah.

Cai Von Rumohr
Analyst, Cowen & Company

So...

Gregory D. Smith

But we’ve got the right discipline in place and having the right discussions with the customers about their needs, the value proposition. And again, back to the efficiency in our production system and the value that it brings back to the shareholders of Boeing, all of that needs to be taken into consideration before we’ll make a final decision.

Cai Von Rumohr
Analyst, Cowen & Company

Right. So give us some specifics. You have this vision to grow the Services business.

Gregory D. Smith

Yeah.

Cai Von Rumohr
Analyst, Cowen & Company

What are the key things you’re looking at and how does M&A fit in there?

Gregory D. Smith

Yeah. Well, look, at the highest level, it’s a $2.6 trillion market and we have 7% share in one business and 9% in the other. That’s kind of where you start. And you look at our products, there are design. We know more about those products, I would argue, than anybody and we think we can bring more value to the customer at the end of the day. So we’re methodically kind of going through how do we do that in bringing these two businesses together and having people 24/7 focused on what we’re bringing to the customer and how do we grow this business and how do we control more of the life cycle that ultimately we think will bring better service to the customer is the primary objective.

Organic is certainly a key part of that and then complementary in inorganic. But again, it’s got to all make sense. It’s got to be able to deliver we think better value to the customer. It’s got to meet our financial hurdles as well and complexity of integration and so on, but it’s vertical focused in certain areas and then life cycle focused.
And so, again, what can we do as Boeing that bring better service and better value back to our customer and ultimately at the same time grow our Services business profitably. So that's what the team's got in place. I think I mentioned on the earnings call, at the same time, focused on efficiency. So again, when you take the Military business and the Commercial business and get behind the customer-facing elements of that business, there's best practices in logistics, in how parts are ordered, how services are offered through things like performance-based logistics contracts on the defense side. So, there's a lot of best practices that that team is now bringing in on the efficiency and the back room that ultimately will impact us competitively with the – and help bring better value back to the customer.

Cai Von Rumohr  
Analyst, Cowen & Company

Right.

Gregory D. Smith  

So, there's a lot in place, lot going on there, but it's great to have the business set up and running. They had a great start in 2017. I think about – we launched it and got it all in place in [ph] 2017 (00:19:19). 2018 is another big year and you heard from the guide that we provided that this is another take-share year for us. So, it's a big year for our Service business.

Cai Von Rumohr  
Analyst, Cowen & Company

So, you've taken in-house a lot of actuation, interiors is the plan, avionics. I was talking to one of your suppliers and their comment was, we know a whole lot more about our systems than they do. We've been doing this for X years, we've gone through the whole thing.

Gregory D. Smith  

Yeah.

Cai Von Rumohr  
Analyst, Cowen & Company

So really, if someone says like, what value are you adding other than just taking it away from the other guys.

Gregory D. Smith  

Yeah. Well, it may not necessarily be a takeaway. There's opportunities to partner here to bring better value as well. So, it's not just to take away by any means, it's – what – again you've got this pretty significant market. And if you look at how services are offered across the entire portfolio on the defense and the commercial side, how can you do that more efficiently. And I think the seats JV is a good example. And that's not necessarily a situation where we have – control all of it. There is a capability that they have. They've made an investment partnering with us, can we bring better value to the customer and we think ultimately to Boeing and to them, we think we can.

So, every one of these is going to be approached a little bit differently. I wouldn't say it's a one-size-fits-all. But I think there's a significant opportunity if going at some of this together that again will be a competitive differentiator when we're offering it to our customer. [indiscernible] (00:20:58) have more knowledge of that particular system,
but I think combined with us, we've got a lot of knowledge of those airplanes that we've designed and developed as well.

Cai Von Rumohr  
Analyst, Cowen & Company

You bring up a good point, so the seating JV has really brought someone who is not a player into being a new player.

Gregory D. Smith  

Yeah.

Cai Von Rumohr  
Analyst, Cowen & Company

So, should we look for other – those sorts of partnerships where you bring someone who’s not viewed as a mainstream guy, who’s coming in because they’re partnering with you?

Gregory D. Smith  

Could be, yeah. I mean, it's not something we're dismissing. So, if there's an opportunity to do that and it makes sense and again kind of meets all the objectives, then we'll do it. And you've seen over the last couple of years, we've expanded capability with other suppliers as well that were on particular programs or on particular lines of technology, and we've helped get them up and running. And I think it's a great opportunity to have a more competitive environment. And I think ultimately that competition makes everybody better and ultimately will make our customers better.

Cai Von Rumohr  
Analyst, Cowen & Company

Right. So if we turn to Defense, you've got a couple of watch list programs, the tanker, CCV. What should we look for to tell us like you're out of the woods and how comfortable are you that we're not going to see another adjustment?

Gregory D. Smith  

Yeah. Well, look, we made a lot of progress on both of the programs certainly and had challenges along the way. But I think when you look at the tanker getting the big milestones obviously, getting aircraft certified. So we just got that certified to FAA, we've got military certs to get through here, but 2018 is a big year, 2018 is the delivery year and again we were out there last week walking the line talking to the team. And from a productivity point of view in the factory, I mean there's a lot of aircraft inflow, each one of them getting better from a cost perspective. But to your point on the development side getting through the initial development of the program, not been a lot of room for error there. But team's done a – make a nice progress and we feel – look, the risk profile has gotten better. And so 2018 is all about delivery to our customer and getting – again getting through these certs will be the next big milestones to watch for, and getting through that first one was again a big significant milestone for the program.
And on commercial crew, another big year for us. This will be the year of delivery and again making good progress, tracking well to the commitment date that we have in place. But to your point, Cai, I mean they are big watchmen for the year, but I think team's got good plans in place, but we've got, I'll say, a heavy operating rhythm on monitoring the programs and helping the teams where they need help, but these are transitional years for both of those programs. I think they're in good shape.

Cai Von Rumohr
Analyst, Cowen & Company

On the call, you've talked about tanker as a cash flow positive this year. How should we think about the profile of the cash? I mean it's been a cash user until now.

Gregory D. Smith

Yeah, it's been a user. It'll start to be a contributor this year and then of course as you move forward and we'll have more tankers in flow and more deliveries, you'll see an improved cash profile on the program. I mean in some of the things again, we saw last week of really bringing some best practices to the production system, cutting flow, cutting hours per unit, just overall efficiency gains. We're seeing more momentum in the factory, which certainly gives you higher confidence as we deliver more of those aircraft, and then when you step back, it's a big market. It's a 400 aircraft market with a highly capable aircraft. So getting into this delivery phase and then really continuing a market that globally, we think it's going to be a great program obviously for the warfighter and for our company. So, full court press on delivery.

Cai Von Rumohr
Analyst, Cowen & Company

So if we look at your commercial — commercial derivative business, I mean over the last year, your head count has been tracking down...

Gregory D. Smith

Yeah.

Cai Von Rumohr
Analyst, Cowen & Company

...basically you have supplier price step downs in front of you. You don't have any labor contract negotiations coming up. I mean it really looks like as good as ever I've seen it in terms of just an environment to do well. I mean, is the head count still going down? And does it look like as good an environment as it seems to me?

Gregory D. Smith

Yeah. I mean look, you're going to have natural attrition. And I mean, that's just going to take place a lot and then program transitions out of development and into production, rate change. So as you know, there's a lot of variables in there. Obviously, what we've been focused on is competing to win. You know competing to win, that is the ultimate job security. And how do you get to a cost structure that allows you to compete to win on a global scale. And so, that's been the focus, Cai, on every element of cost. It's not just head count, it's every aspect of cost that we are setting, I'll say, a new standard for ourselves that is all about ultimately delivering better value to
the customer and pricing and cost structure and returns back to Boeing, but competing to win and setting that bar at a different level than we've set it before, and we all have accountability.

So everybody on the team has their piece, key element of that, change in the comp structure. 50% of everybody's comp is free cash, 25% revenue, and 25% [ph] earnings (00:26:53). Again getting everybody aligned to what the key objectives are efficiency, winning in the marketplace, alignment directly back to our guidance, and alignment to what we've all committed to our shareholders, and what we report on a quarterly basis and annual basis. That's been also kind of a key element of driving the productivity.

One of the key responsibilities that I have is the One Boeing objective, taking these best practices. I have the privilege of seeing the entire operation and seeing some phenomenal things that our people are doing in space, rotorcraft, fighters, 787 services, and taking those best practices and driving them across Boeing. And I think we've done a good job, but we have a significant opportunity. And Services was a key objective of doing that like we talked about, but efficiency like they said on the 787. If you go out to tanker, there's people there that were on other programs bringing best price, so enabling more of that. But think about it, this is about meeting our financial objectives, better value to our customer and winning, getting a winning mindset across the entire enterprise that we're competing to win every day and that's going to fund our future. So, what do we need to do to ensure we do that, cycle time, first-time quality, cost and ultimately pricing. That's fundamentally what we're trying to do.

Cai Von Rumohr
Analyst, Cowen & Company

So when you think about your head count's been tracking a little bit flat to down, but on the other hand, there's also been something of a retirement [indiscernible] (00:28:32).

Gregory D. Smith

Yeah.

Cai Von Rumohr
Analyst, Cowen & Company

How are you doing in terms of hiring and the quality of people coming on board and the time to come and get them productive? Is that good?

Gregory D. Smith

It's a great question. It's a great – frankly as a leadership team, we spend a lot of time on talent, attracting top talent and retaining top talent, but addressing the demographics is a key element of that, but I think we hired roughly about 12,000 people last year. So as head count did go down and we had natural attrition, we were out actively recruiting at all levels of our company and bringing the best to Boeing. And that's going to continue, Cai, but succession planning, focus on demographics, there's a lot of lessons learned, these people have. So how do you transfer those lessons before they leave, mentorship programs, training programs where we have seasoned leaders trained our folks. I have the program in general management function as well for the company. The gentleman I have leading that is, big focus for him is again sharing that talent, succession planning, where are we recruiting? How we are retaining training? How are we reaching deep into the organization and getting the right people into the right positions to fill, as you know the demographics shift and people retire, but again the key element of that is – is that transferred learning that those mentorship programs that are critically important, you're learning from these folks that have 30, 40 years of experience that they want to share. That's frankly the beauty of
the folks of Boeing. They want to share it, they feel responsible to share it. So how do we do that and tag them up with that next generation coming in, so they're better prepared to address those challenges going forward. So, big focus area for us.

Cai Von Rumohr
Analyst, Cowen & Company

Got it. So if we turn to the foreign business for Defense, it's like 40% of your backlog. It's bigger than most of your competitors.

Gregory D. Smith

Yeah.

Cai Von Rumohr
Analyst, Cowen & Company

What are the key opportunities we have this year going forward and could that number move up?

Gregory D. Smith

Yeah, I mean, look, I think on a global scale, we still see that to be a pretty attractive market. I would say from rotorcraft to fighters, to P-8s and I mentioned tanker earlier, those are some of the key opportunities globally. But I think, Cai, that's another great example of this whole One Boeing objective. Our campaign reviews now are the Head of Sales for our Defense business, but also the Head of Sales for BCA is part of those reviews. So how are you really leveraging the One Boeing to compete to win, and in some cases, our Commercial business has more in-country experience in certain regions of the world than our BDS business or vice versa. We're trying to enable that to take place by, first of all, getting everybody on one score from an incentive program perspective, and then those three key elements I mentioned are a key enabler, I'll say, to drive the right behavior, but it's leveraging that experience.

So we think there's lot more opportunity on the international front, but again I think, think about it, we're going after this as One Boeing, whether it's fulfilling offset agreements that I think is a competitive differentiator for us that we can do that, but going after fighter campaigns, going after rotorcraft campaigns and doing it as a company, not as a program, not as a division and competing to win. What's the best that we can bring to Boeing to enable that sale, and I think that's what you see in the 40%, but I think there's still a lot more opportunity for us there, and that's going to play out in the Services as well.

Cai Von Rumohr
Analyst, Cowen & Company

Right. So your target -- you announced target is to get to mid-teens margins quite a bit above where you are today?

Gregory D. Smith

Yeah.
Cai Von Rumohr
Analyst, Cowen & Company

What's the take to get there? Can all three businesses reach that goal?

Gregory D. Smith

Well, look, yeah, that's the objective we put in place for the team, and this is about raising the bar. This is about looking at the investments we make in the business, the risk profile and appropriate return on that. And then setting the bar more outside the industry, but kind of more of a global industrial champion kind of mindset and then backing into it. What's the cost structure need to look like? This is back to just competing to win, this is about again [ph] meeting (00:33:22) an objective to reinvest back in innovation, all kind of the cycle back to bringing the best products and services to the market that funding it. That's kind of the broader objective, but we all have targets. Everybody in the company has targets that align to this, we call, global industrial champion that gets to that kind of mid-teens margin objective.

Now, are some of them more challenging than others? Absolutely, they are. But is it the right mindset to have? Absolutely, it is. It absolutely is the right mindset to have and it's across the company. But again it's about really raising the bar and really challenging the status quo and bringing in best practices whether they're in the industry, whether they're in the company. I mean we have programs that are operating at global industrial champion today in the company. Get them and bring them over to the program that is in and learn from it. Don't reinvent the wheel and reinvest, take those lessons [ph] from everybody (00:34:21) and enable that because we have it in the company. So we don't have to look too far outside our four walls to find programs that I could check the box on whether it's still on-time delivery, customer service, margins, working capital; I could check the box down there and they are in the company today, so you don't have to go out too far.

Having said that, we are benchmarking with other companies on every aspect of the operation cost, how they service their customers and so on. And really again trying to – this mindset of competing to win and leveraging best practices, no matter where they are, to make us more efficient and more effective and first-time quality flow time, cost to finance, I have a cost to finance for the entire company target that is global industrial champion, so my job is to meet that target. That's my piece beyond the other pieces to meet that target, my piece of that mid-teens margin, and that drives me to where can I [Technical Difficulty] (00:35:29), where can I be more efficient as far as financial resources we're bringing, where there may be sourcing opportunities, it's that kind of a mindset. But everybody in the company, everybody on Dennis' leadership team has that element on their scorecard that we review monthly and quarterly. Again, not all the plans in place to get there across the company, absolutely not.

Cai Von Rumohr
Analyst, Cowen & Company

Right.

Gregory D. Smith

But each as we move through time, plans are maturing and we're leveraging some or more of those best practices and getting in place. But it's absolutely, I think, the right mindset to have.

Cai Von Rumohr
Analyst, Cowen & Company
Right. So if we look at the Tax Act, you look like a major beneficiary. You are a U.S. exporter. You basically have the 787 deferred, so you have to pay at a lower rate than you are expected, you have bonus depreciation. So I was a little surprised on the Q4 call to have you say that the cash taxes would go up in 2018. Maybe give us some perspective on the benefits you get from the Tax Act and why the cash taxes might be up here?

Gregory D. Smith  

Yeah. Yeah, absolutely. I mean look, at the highest level like I said, this is competing to win on a global scale. That's why tax reform is so important. And I believe that will drive our economy and really again allow us to compete in places that have been challenging to compete primarily in some cases purely because of the tax rate. So we were a big supporter of tax reform and very pleased to see it passed. And it's going to make us all better and be able to compete again more on a global scale.

When you look at the rate of the 21% and we guided to 16%, two major elements in there obviously, R&D tax credit and then I'll say the export credit and this is about us making over 90% of our product here in the United States and over 75% of it being exported. And so, that's fundamentally what gets you to the 16% rate.

From a cash perspective, as 787 improves on a unit basis, we pay more cash taxes. We will pay less cash taxes than we were projecting under this new rate, but cash taxes are a headwind in 2018 and they will continue to be in 2019 just not as much as they were at the prior rate.

Cai Von Rumohr  
Analyst, Cowen & Company

Got it. So you talk of cash flow increasing through 2020. What are the key drivers to get you there, given the 777 Classic is declining?

Gregory D. Smith  

Yeah.

Cai Von Rumohr  
Analyst, Cowen & Company

777X is a new program. Presumably you consume a lot of cash. What gets you home?

Gregory D. Smith  

Yeah. Well, look, to your point, there's a lot of moving pieces. I think fundamentally at the highest level, it's delivering on the backlog. It's delivering on the seven years of production that is the biggest enabler to cash along with the efficiencies that I talked about in capturing those, but it's meeting those rate breaks on time, do it efficiently as we have. It's the biggest driver of cash flow. Is there the moving pieces within that year-over-year as you mentioned. 2018, 737 will improve, 787 will improve, tanker will improve, some headwinds, cash taxes, 777, lower 777 rate combined with bringing the 777X in, so we're building inventory there. With that, all those 737, 787 and so on and tanker more than offset that that allows us to continue to grow. So, every year, there're some moving pieces in there, but we're focused on growing it. We think there's more opportunity to do that. And it's first and foremost meeting our commitments on the rates and at the same time driving the efficiencies I talked about that include working capital. And as I mentioned on the call, 50% of everybody's incentive is free cash.
So really again not just driving, I'll say, other areas of efficiency but really driving inventory levels, payables, receivables, again best practices. We've got programs that are running at inventory turns that are best-in-class, and you take that best practice and bring them across, so reducing flow times, elements like that and having the team attach cash flow to that, so they fully understand what's the line position cost, what's the cost of having that aircraft in that position for three days. If you could take it to two, what's the cost of that to one and driving that right behavior and the right incentives in place that will also contribute to cash flow going forward. So, lots of moving pieces, but we expect it to continue to grow over time.

Cai Von Rumohr  
Analyst, Cowen & Company

Right. We just have – we have time for one more question.

Gregory D. Smith  

Sure.

Cai Von Rumohr  
Analyst, Cowen & Company

But so I guess you said that you've kind of been working with Embraer. I guess the news reports have reported that there is a working group who sort of see if does this make sense. What attracts you to Embraer, why is that sort of something that would be a win-win?

Gregory D. Smith  

Yeah, no, it's a great question. Look, it's a great company. It's a great company with a great product line and one that quite frankly is complementary when you look at — on the Commercial side, when you look at our product line and theirs and even on some of the defense products, very complementary to what we do. They run a great company. Again, they've got a great product offering and we think, combined, we could really compete on a different scale. So again, it's complementary. We're in active discussions and productive discussions and being very mindful and being very respectful to the Brazilian government's priorities and needs as well as Embraer's and we'll see whether we can find the right structure that's in place that ultimately again is going to deliver best value back to our customers and to our shareholders. But this is a company that we've been collaborating with for many, many years. So we know everybody well. There's a lot of efficiencies that we think, combined, will allow us to again back to that competing to win in the marketplace.

Having said that, Cai, look, if we can't find an agreement that works, then we'll move forward. It's not a have-to, but it would be certainly a nice-to-have and we think a very complementary combination of portfolio. So we'll continue to have active dialog and we're optimistic that we can find a path forward here that would be again good for our customers and for our shareholders and good for the Brazilian government and the folks of Brazil as well.

Cai Von Rumohr  
Analyst, Cowen & Company

Terrific. Thank you very much.

Gregory D. Smith  
Cai, thank you so much.