

Aerospace and Defense Industry - Key Success Factors

BUSINESS RISK ASSESSMENT

Market Position

The analysis covers comprehensive assessment of the company's competitive advantages in the industry. We believe that companies with a strong competitive advantage in this sector are able to spread out costs and enjoy more economies of scale. The assessment is further broken down to the company's position in the industry, production capacity, production capability, relationship with customers, and the size of its order backlog, the latter of which is an indicator of future production as well as future revenue and cash flows. The strategic importance of the products it manufactures and/or services it provides are also assessed as it will determine its position in the market. Aerospace and defense companies usually provide products and services as part of an overall spending program by its end-customer, and the program's degree of importance to the customers will eventually determine the contract received to the company. We are of the view that most of the products or services provided by the aerospace and defense companies are essential as it is highly related to safety requirements as well as national security. We also review its production capacity and facility offered by the company, which will determine its broad product or service offering to its end-customers. We also assess the relationship characteristics (length, depth, and breadth) with its customers, particularly for defense contractors which is exposed to potential political influence and defense spending cuts as well as the negotiating power that the Ministry of Defense hold over contractors, which generally limits the margin in the industry.

Diversification

The assessment will include examining how well the company's ability to provide various products or services enables it to capture broader market segments with different demand characteristics. Having broad product lines or services lessen business risk and can mitigate cyclical pressures. New products or services offering, which give a value increase to customers will enable the price base to be adjusted. In terms of customer base, customer diversity can ease price pressures and protect against a sudden loss of demand. The number and location of facilities that will help the company get closer to its customers, including aftermarket services, will also be considered and how good its distribution channels are. Geographic diversity is also important. Regions may be in different business cycle stages and experience different severity of cyclicity, particularly in the local and export markets.

Technology leadership and competency

The analysis covers a comprehensive assessment of the company's contracting and technology capability, patents, and technology under development to ensure the company's ability to deliver service or production in a timely manner given the fact that the nature of some of the customer's contracts is such that cost overruns and delays are covered by the contractor, which could lead to a significant cash impact if the programs run into trouble. Therefore, a track record of successful program execution and good project management tend to be rated higher. We also assess the company's ability to integrate complex technology into its products or services. We further consider the company's competency level on licenses, certifications requirements in the industry, and qualified human resources for its services and products. A company's history and commitment to innovation and development of new technologies, which are key to maintaining market leadership positions, are also assessed.

Operating Management

The analysis includes an assessment of the management's policy and strategy to support the company's business performance. Its ability to control operating costs, including raw material procurement, will be reflected in its strong profitability and cash flow generation. A good cost position, along with a reasonable

capital structure, should enable a contractor to generate positive operating cash flow, even during an economic slowdown. The analysis of operating margins (EBIT and EBITDA) is also assessed by comparing the company's ratios with other players in the same industry or other industries with similar characteristics, which is important in analyzing the company's competitiveness. The analysis is helpful to measure operating efficiency. We will also assess the company's working capital management and how efficiently the company uses its assets to optimize profits. In analyzing a company's working capital, we will have a comprehensive look at the assets and liabilities that are related to the contract, which includes the quality of inventory, the marketing and risk management plan, receivables and collections, advance payment pattern, and the status of its accounts payable and availability of credit lines. Most of the aerospace and defense companies may require heavier investment in terms of working capital, particularly for products that have long production lead-times as some of the materials need to be retained before the finished product is delivered. Seasonal movements in working capital will affect liquidity during the financial year, mainly due to the timing of funds received from the customers as opposed to the timing of the product is delivered or project phases. We believe that an unexpected and significant change in working capital relative to the revenue or profitability of the company can indicate a potential liquidity concern in a market downturn as it will further increase the cash burn rate and consequently may lead to deteriorating credit quality. For companies that carry a backlog of orders, we also consider production lead-time versus their competitors or peers, the margin profile of projects in the backlog, and the degree of project risks to which the company is exposed.

FINANCIAL RISK ASSESSMENT

Financial Policy

The analysis includes a review of management's philosophy, strategy and policies toward financial risk (historical, current and future). It also includes examination of management's financial targets (growth, leverage, debt structure and dividend policy), hedging and other policies in an effort to reduce the company's overall financial risk (historical vs. future). The company's track record on fulfilling its previous financial obligations is also examined to determine the degree of its commitments and willingness, and consistency to pay obligations on a timely basis.

Capital Structure

The analysis covers careful examination of the company's historical, current and projected leverage (total and net debt in relation to equity and EBITDA), debt structures and composition (rupiah vs. foreign currencies, short-term debt vs. long-term debt, fixed rate vs. floating rate). Management of its liabilities is also thoroughly reviewed.

Cash Flow Protection and Liquidity

The analysis covers thorough reviews of the company's cash flow generation and capability to meet its short-term and long-term financial obligations. The degree of its debt-servicing capability level is measured by the company's interest and debt coverage ratio. The degree of its liquidity in fulfilling its short-term liabilities relative to its sources of cash is also thoroughly assessed. The sources of cash are assessed, which include cash balance, estimated cash from operations, unused credit facilities, and other sources of cash. The uses of cash other than short-term liabilities, such as capital expenditure, are also assessed.

Financial Flexibility

The analysis covers combined evaluations of all the financial measures above to arrive at an overall view of the company's financial health. Analysis of other related factors or figures that are not specifically examined above, such as insurance coverage, restrictive covenants in loan/bond agreements or parental

linkage and support, are also covered. Other analytical tasks covered are the evaluation of the company's options under stress, including contingency plans and other capabilities and flexibility to deal with various adverse scenarios. Shareholder support and commitment are also greatly considered.

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