

AAR Corp. (AIR)

\$15.08 (As of 05/14/20)

Price Target (6-12 Months): **\$16.00**

Long Term: 6-12 Months

Zacks Recommendation:

Neutral

(Since: 04/20/20)

Prior Recommendation: Underperform

Short Term: 1-3 Months

Zacks Rank: (1-5)

3-Hold

Zacks Style Scores:

VGM:A

Value: A

Growth: D

Momentum: A

Summary

AAR Corp. continues to witness strong performance in its parts supply and program activities. Strategic investments toward AAR Corp.'s parts supply activities have enabled the company to capitalize on steady parts demand. Additionally, it expects elevated demand for used materials as airline companies look to save money using aftermarket parts. AAR Corp., being the largest aftermarket parts supplier in the world, will benefit from increased supply. However, it has underperformed the industry in the past year. AAR Corp. continues to witness labor shortages in its MRO business and the issue is expected to linger in the near term. It also operates in a space that is highly competitive. Further, the company expects the global impact of the coronavirus outbreak to significantly mar its commercial airline business.

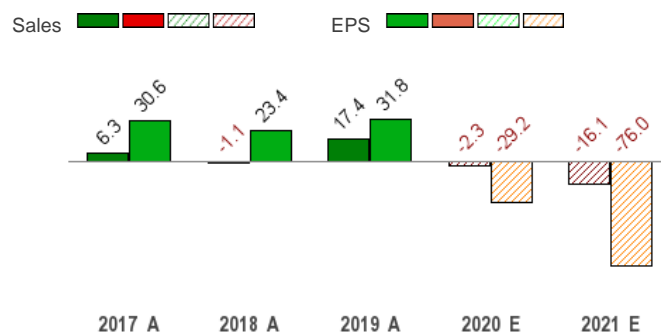
Price, Consensus & Surprise



Data Overview

| | |
|----------------------------|--|
| 52 Week High-Low | \$52.78 - \$8.56 |
| 20 Day Average Volume (sh) | 376,928 |
| Market Cap | \$529.3 M |
| YTD Price Change | -66.6% |
| Beta | 1.66 |
| Dividend / Div Yld | \$0.30 / 2.0% |
| Industry | Aerospace - Defense Equipment |
| Zacks Industry Rank | Bottom 21% (199 out of 253) |

Sales and EPS Growth Rates (Y/Y %)



| | |
|---------------------------|-------------------|
| Last EPS Surprise | 1.5% |
| Last Sales Surprise | -0.8% |
| EPS F1 Est- 4 week change | 0.0% |
| Expected Report Date | 07/08/2020 |
| Earnings ESP | 0.0% |
| P/E TTM | 6.0 |
| P/E F1 | 9.0 |
| PEG F1 | NA |
| P/S TTM | 0.2 |

Sales Estimates (millions of \$)

| | Q1 | Q2 | Q3 | Q4 | Annual* |
|------|-------|-------|-------|-------|---------|
| 2021 | 370 E | 392 E | 432 E | 487 E | 1,681 E |
| 2020 | 542 A | 561 A | 553 A | 344 E | 2,004 E |
| 2019 | 466 A | 493 A | 530 A | 563 A | 2,052 A |

EPS Estimates

| | Q1 | Q2 | Q3 | Q4 | Annual* |
|------|-----------|----------|----------|-----------|----------|
| 2021 | -\$0.10 E | \$0.04 E | \$0.12 E | \$0.33 E | \$0.40 E |
| 2020 | \$0.57 A | \$0.64 A | \$0.67 A | -\$0.22 E | \$1.67 E |
| 2019 | \$0.54 A | \$0.59 A | \$0.79 A | \$0.64 A | \$2.36 A |

*Quarterly figures may not add up to annual.

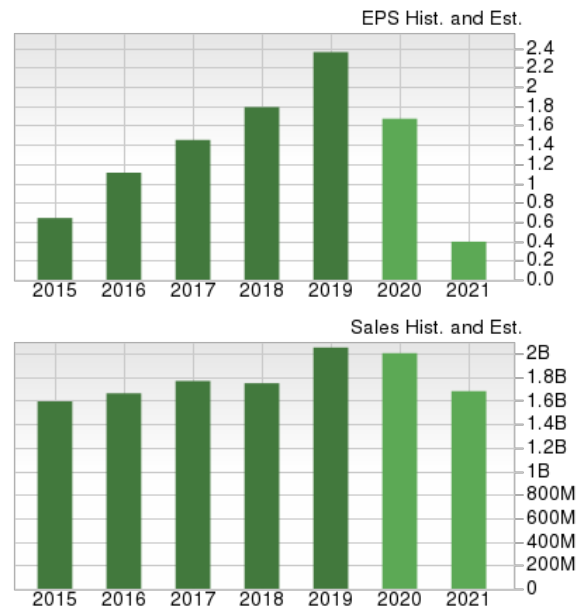
The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 05/14/2020. The reports text is as of 05/15/2020.

Overview

Wood Dale, IL-based AAR Corp., incorporated in the year 1951, provides various products and services to the aviation and defense industries worldwide. Its principal customers include The Boeing Company and Airbus. The company now reports through two business segments – **Aviation Services** and **Expeditionary Services** – following the divestiture of Telair Cargo Group and the planned sale of Precision Systems Manufacturing.

The *Aviation Services* segment comprises supply chain maintenance, repair and overhaul (MRO) activities. This segment provides aftermarket support and services for the commercial aviation and government and defense markets. It provides inventory management and distribution services, overhaul, repair and engineering services. Segment sales in fiscal 2019 were \$1,920.6 million, representing 93.6% of the company's total sales.

The *Expeditionary Services* segment includes airlift and mobility activities. This division provides products and services for the movement of equipment and personnel by the U.S. Department of Defense (DoD), foreign governments and non-governmental organizations. This segment also designs manufactures and installs in-plane cargo loading and handling systems for commercial aircraft, military aircraft and helicopters. Sales during fiscal 2019 came in at \$131.2 million, contributing 6.4% to the company's total sales.



Reasons To Buy:

- ▲ AAR Corp. continues to witness strong performance in its parts supply and program activities. In fact, solid sales from its parts supply activities have been one of the primary catalysts behind the company's fiscal third-quarter top-line growth. The company's investments toward its parts supply activities have enabled it to capitalize on the continued robust demand for parts.
- ▲ Additionally, it expects elevated demand for used materials as airline companies look to save money using aftermarket parts. AAR Corp., being the largest aftermarket parts supplier in the world, will benefit from increased supply. Moreover, the company anticipates the competition in the aftermarket, which has intensified in recent years due to the length of the up cycle, will decrease as competitors struggle to survive or increasingly focus on core activities. Banking on such initiatives, management expects to witness continued growth in the company's parts supply business in the days ahead.
- ▲ Coming to its latest business wins, during the fiscal third quarter, the company was selected by AeroControlex, a large manufacturer of critical components to the aviation industry, to be the latter's exclusive global distributor for the APU lube pump product line. AAR Corp. also secured a \$90-million sole-source IDIQ contract with the Defense Logistics Agency for specialized shipping and storage containers as well as accessories. Also during the quarter, the company announced plans to expand its airframe maintenance services with Air Canada to cover the A330 fleet. Such significant contract wins reflect growth prospects for the stock.

Solid performance from its parts supply program boosts AAR Corp's top line. Recent distributor agreements should bode well for the stock.

Reasons To Sell:

▼ AAR Corp has been witnessing labor shortages in its MRO business for quite some time. Indeed, North America is facing labor shortage issues in its aviation industry, which has now been translated in to the aftermarket MRO industry. To this end, Oliver Wyman, a leading global management consulting firm, predicted in April 2018 that technician supply will be challenging over the next five years for the MRO aviation space, which could result in increased labor costs. Therefore, the growth prospects of AAR Corp's MRO business seem to be bleak.

Labor shortage issues in MRO business and stiff competition may limit the growth prospects of AAR Corp.

▼ In 2019, the U.S. Department of Justice (DoJ) conducted an investigation of AAR Corp.'s Airlift business segment, under the federal civil False Claims Act (FCA). The investigation was carried out, as Airlift's performance related to several contracts awarded by the U.S. Transportation Command, concerning the operations and maintenance of rotary-wing and fixed-wing aircraft in Afghanistan and Africa, was scrutinized. Considering these events, AAR Corp ultimately decided to divest its Airlift assets. This divestment might negatively impact the company's operating results, as it will lose the contracts it used to win for the Airlift business. This, in turn, will likely dampen investors' confidence in the stock. In the past year, shares of AAR Corp have plunged 53.2% compared with the industry's 44.7% decline.

▼ AAR Corp's cash equivalents as on Feb 29, 2020, remained much lower compared to its long-term debt levels. Evidently, at the end of the third-quarter fiscal 2020, its cash equivalents were \$65 million, while its long-term debt stood at \$286 million as of Feb 29, 2020. A comparative analysis of these figures reflects the fragility of AAR Corp's cash reserve, against its long-term debt value. Considering this and the ongoing uncertainty related to the COVID-19 pandemic makes us skeptic about the company's ability to duly meet its obligations in the near future.

Moreover, the company's interest coverage came in at 9.7 as of Feb 29, 2020, down sequentially from 12.1 and also lowest in the last four quarters. Moreover, its debt-to-capital ratio as of Feb 29, 2020 was 0.24, compared to 0.23 in the prior quarter and also highest among the last four quarters. Together these indicate that AAR Corp. might face difficulties and struggle to meet debt obligations, at least in the near future.

Last Earnings Report

AAR Corp. Earnings Beat Estimates in Q3, Sales Miss

AAR Corp. reported third-quarter fiscal 2020 adjusted earnings of 67 cents per share, which surpassed the Zacks Consensus Estimate of 66 cents by 1.5%. The figure also reflected a year-over-year improvement of 8.1% from 62 cents.

Excluding one-time items, the company reported earnings of 7 cents from continuing operations compared with 78 cents in third-quarter fiscal 2019.

Quarter Ending **02/2020**

| Report Date | Mar 24, 2020 |
|------------------|--------------|
| Sales Surprise | -0.80% |
| EPS Surprise | 1.52% |
| Quarterly EPS | 0.67 |
| Annual EPS (TTM) | 2.52 |

Total Sales

In the reported quarter, net sales of \$553.1 million missed the Zacks Consensus Estimate of \$558 million by 0.9%. However, the top line grew 4.5% from \$529.5 million in the year-ago quarter.

The year-over-year improvement in sales was driven by continued growth in the company's Aviation Services segment.

Segment Details

In the fiscal third quarter, sales from the Aviation Services segment summed \$530.3 million, up 6.6% year over year.

Expeditionary Services registered sales of \$22.8 million, down 29.1% from \$32.2 million in the year-ago quarter.

Highlights of the Release

AAR Corp.'s cost of sales in the reported quarter increased 9.8% year over year to \$487.8 million.

Selling, general and administrative expenses rose 6% to \$58.1 million.

The company incurred interest expenses of \$2.3 million compared with \$2.4 million in third-quarter fiscal 2019.

During the quarter, the company paid out cash dividends of \$2.6 million, in line with the cash dividends paid out in third-quarter fiscal 2019.

Financial Condition

As of Feb 29, 2020, AAR Corp.'s cash and cash equivalents amounted to \$37 million compared with \$21.3 million, as of May 31, 2019.

As of Feb 29, 2020, net property, plant and equipment expenses were \$136.7 million compared with \$132.8 million, as of May 31, 2019.

As of Feb 29, 2020, long-term debt decreased to \$206 million from \$141.7 million, as of May 31, 2019.

Recent News

On **May 8, 2020**, AAR Corp's Integrated Technologies division has been awarded a firm-fixed-price (FFP) contract from the US Air Force Life Cycle Management Center (AFLCMC) Tinker AFB, Oklahoma, to provide contractor logistical support (CLS) for a fleet of 18 AN/MSN-7 Communication Central Systems. The support requirements include program management, supply of all the AN/MSN-7 parts, support equipment components, all system materials and consumables as well as replenishment of spare parts. The effort also requires AAR to provide depot-level maintenance and system level down to Line Replaceable Unit (LRU) level repair as needed, procurement, and installation services on an as required basis. The firm-fixed-price contract with AAR Integrated Technologies is for five years (base year with four one year renewal options) for an estimated value of \$5.1 million.

On **April 15, 2020**, AAR Corp's Mobility Systems division, was awarded a sole-source firm-fixed-price (FFP) contract from the US Army to produce three variants of Lightweight Multipurpose Shelters (LMS). These shelters will be manufactured at AAR Mobility Systems in Cadillac, Michigan. The sole-source firm-fixed-price (FFP) contract with AAR Mobility Systems is for five years for an estimated value of \$11.9 million.

On **March 31, 2020**, AAR Corp. and Sumitomo Corporation, announced the launch of their joint venture, AAR Sumisho Aviation Services. This Chicago-area-based joint venture will distribute aircraft parts and offer aviation logistics management solutions to the Japanese defense market. Additionally, the partnership will distribute parts from OEMs based in Japan to the global aviation aftermarket.

This business initiative builds upon the parties' successful, long-standing relationship, under which AAR Corp. has served as a stocking distributor for OEM factory-new parts to Japanese defense customers via Sumitomo Corporation since 2012.

On **Feb 12, 2020**, AAR Corp. announced a Memorandum of Understanding (MOU) to provide consulting services for Korean Aerospace Engineering & Maintenance Services (KAEMS). The two companies will collaborate to define required capabilities and infrastructure for a new KAEMS facility in South Korea that will provide component maintenance for the Republic of Korea Air Force's (ROKAF) F-16 fleet. The MOU includes training for KAEMS employees at AAR's component repair facilities in Amsterdam and New York.

Valuation

AAR Corp.'s shares are down 66.6% in the year-to-date period and 53.2% over the trailing 12-month period. Stocks in the Zacks sub-industry and the Zacks Aerospace sector are down 50.2% and 38.2% in the year to date period, respectively. Over the past year, the Zacks sub-industry and sector are down 44.7% and 35.9%, respectively.

The S&P 500 index is down 11.5% in the year to date period and 1.2% in the past year.

The stock is currently trading at 33.5X forward 12-month earnings, which compares to 19.4X for the Zacks sub-industry, 18.5X for the Zacks sector and 20.7X for the S&P 500 index.

Over the past five years, the stock has traded as high as 40.1X and as low as 3.3X, with a 5-year median of 16.3X. Our Neutral recommendation indicates that the stock will perform in line with the market. Our \$16 price target reflects 35.5X forward 12-month earnings.

The table below shows summary valuation data for AIR

| Valuation Multiples - AIR | | | | | |
|---------------------------|---------------|-------|--------------|--------|---------|
| | | Stock | Sub-Industry | Sector | S&P 500 |
| P/E F12M | Current | 33.45 | 19.44 | 18.54 | 20.67 |
| | 5-Year High | 40.06 | 20.89 | 20.94 | 20.79 |
| | 5-Year Low | 3.28 | 12.99 | 14.17 | 15.19 |
| | 5-Year Median | 16.28 | 17.11 | 17.16 | 17.45 |
| P/S F12M | Current | 0.31 | 0.72 | 1 | 3.22 |
| | 5-Year High | 0.8 | 1.29 | 1.49 | 3.44 |
| | 5-Year Low | 0.14 | 0.72 | 0.92 | 2.54 |
| | 5-Year Median | 0.61 | 1.01 | 1.17 | 3.02 |
| EV/EBITDA TTM | Current | 4.93 | 6.53 | 10.56 | 10.32 |
| | 5-Year High | 22 | 12.02 | 15 | 12.86 |
| | 5-Year Low | 3.68 | 6.21 | 7.38 | 8.28 |
| | 5-Year Median | 9.88 | 8.77 | 10.48 | 10.77 |

As of 05/14/2020

Industry Analysis Zacks Industry Rank: Bottom 21% (199 out of 253)



Top Peers

| Company (Ticker) | Rec | Rank |
|---|--------------|------|
| Aerojet Rocketdyne Holdings, Inc. (AJRD) | Neutral | 3 |
| Astronics Corporation (ATRO) | Neutral | 3 |
| AeroVironment, Inc. (AVAV) | Neutral | 3 |
| CurtissWright Corporation (CW) | Neutral | 3 |
| Heico Corporation (HEI) | Neutral | 4 |
| Kratos DefenseSecurity Solutions, Inc. (KTOS) | Neutral | 3 |
| Hexcel Corporation (HXL) | Underperform | 5 |
| Triumph Group, Inc. (TGI) | Underperform | 5 |

| Industry Comparison Industry: Aerospace - Defense Equipment | | | | Industry Peers | | |
|---|----------|------------|-----------|----------------|----------|--------------|
| | AIR | X Industry | S&P 500 | AJRD | ATRO | HXL |
| Zacks Recommendation (Long Term) | Neutral | - | - | Neutral | Neutral | Underperform |
| Zacks Rank (Short Term) | 3 | - | - | 3 | 3 | 5 |
| VGM Score | A | - | - | F | B | F |
| Market Cap | 529.32 M | 917.30 M | 18.95 B | 3.05 B | 237.12 M | 2.34 B |
| # of Analysts | 2 | 3 | 14 | 2 | 2 | 3 |
| Dividend Yield | 1.99% | 0.00% | 2.2% | 0.00% | 0.00% | 2.42% |
| Value Score | A | - | - | D | B | F |
| Cash/Price | 0.10 | 0.10 | 0.06 | 0.28 | 0.70 | 0.13 |
| EV/EBITDA | 5.31 | 6.42 | 11.58 | 8.14 | 3.55 | 5.99 |
| PEG Ratio | NA | 2.35 | 2.60 | NA | NA | 3.94 |
| Price/Book (P/B) | 0.57 | 1.67 | 2.59 | 4.95 | 0.75 | 1.65 |
| Price/Cash Flow (P/CF) | 4.17 | 5.60 | 10.20 | 14.29 | 3.81 | 5.31 |
| P/E (F1) | 9.11 | 16.69 | 19.00 | 22.07 | NA | 22.21 |
| Price/Sales (P/S) | 0.24 | 0.82 | 1.93 | 1.55 | 0.33 | 1.02 |
| Earnings Yield | 11.07% | 4.53% | 5.05% | 4.53% | -36.58% | 4.49% |
| Debt/Equity | 0.31 | 0.35 | 0.75 | 0.63 | 1.06 | 0.98 |
| Cash Flow (\$/share) | 3.62 | 2.02 | 7.01 | 2.72 | 2.02 | 5.29 |
| Growth Score | D | - | - | D | A | F |
| Hist. EPS Growth (3-5 yrs) | 37.86% | 10.56% | 10.82% | 37.62% | -23.19% | 10.08% |
| Proj. EPS Growth (F1/F0) | -29.24% | -16.99% | -10.48% | 4.14% | -409.89% | -64.31% |
| Curr. Cash Flow Growth | 22.00% | 9.60% | 5.68% | -8.04% | -23.43% | 12.73% |
| Hist. Cash Flow Growth (3-5 yrs) | -5.67% | 4.37% | 8.52% | 70.16% | -8.28% | 9.27% |
| Current Ratio | 2.39 | 2.39 | 1.27 | 1.67 | 4.11 | 3.36 |
| Debt/Capital | 23.53% | 33.53% | 44.25% | 38.69% | 51.48% | 49.44% |
| Net Margin | 1.97% | 5.27% | 10.54% | 6.80% | -12.89% | 12.10% |
| Return on Equity | 9.69% | 9.58% | 16.29% | 21.60% | 3.49% | 19.92% |
| Sales/Assets | 1.31 | 0.73 | 0.54 | 0.74 | 0.91 | 0.71 |
| Proj. Sales Growth (F1/F0) | -2.32% | 0.00% | -2.55% | 3.33% | -36.31% | -50.86% |
| Momentum Score | A | - | - | D | F | D |
| Daily Price Chg | -0.85% | -0.34% | 1.17% | -2.29% | -1.41% | 4.90% |
| 1 Week Price Chg | -0.71% | 0.22% | 3.23% | 1.27% | -0.51% | -6.10% |
| 4 Week Price Chg | -9.48% | -4.62% | 1.06% | -7.32% | 2.53% | -4.66% |
| 12 Week Price Chg | -66.31% | -30.97% | -22.80% | -28.55% | -68.22% | -63.22% |
| 52 Week Price Chg | -53.27% | -29.00% | -12.40% | 5.34% | -81.67% | -60.40% |
| 20 Day Average Volume | 376,928 | 223,842 | 2,553,422 | 571,002 | 382,889 | 1,993,135 |
| (F1) EPS Est 1 week change | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |
| (F1) EPS Est 4 week change | 0.00% | -9.04% | -5.57% | -9.04% | -47.48% | -27.26% |
| (F1) EPS Est 12 week change | -36.26% | -28.70% | -16.22% | -12.98% | -166.06% | -64.65% |
| (Q1) EPS Est Mthly Chg | 0.00% | -17.13% | -11.63% | -8.27% | NA | -12.50% |

Zacks Stock Rating System

We offer two rating systems that take into account investors' holding horizons: Zacks Rank and Zacks Recommendation. Each provides valuable insights into the future profitability of the stock and can be used separately or in combination with each other depending on your investment style.

Zacks Recommendation

The Zacks Recommendation aims to predict performance over the next 6 to 12 months. The foundation for the quantitatively determined Zacks Recommendation is trends in the company's estimate revisions and earnings outlook. The Zacks Recommendation is broken down into 3 Levels; Outperform, Neutral and Underperform. Unlike many Wall Street firms, we have an excellent balance between the number of Outperform and Neutral recommendations. Our team of 70 analysts are fully versed in the benefits of earnings estimate revisions and how that is harnessed through the Zacks quantitative rating system. But we have given our analysts the ability to override the Zacks Recommendation for the 1200 stocks that they follow. The reason for the analyst over-rides is that there are often factors such as valuation, industry conditions and management effectiveness that a trained investment professional can spot better than a quantitative model.

Zacks Rank

The Zacks Rank is our short-term rating system that is most effective over the one- to three-month holding horizon. The underlying driver for the quantitatively-determined Zacks Rank is the same as the Zacks Recommendation, and reflects trends in earnings estimate revisions.

Zacks Style Scores

The Zacks Style Score is as a complementary indicator to the Zacks rating system, giving investors a way to focus on the highest rated stocks that best fit their own stock picking preferences.

Academic research has proven that stocks with the best Value, Growth and Momentum characteristics outperform the market. The Zacks Style Scores rate stocks on each of these individual styles and assigns a rating of A, B, C, D and F. We also produce the VGM Score (V for Value, G for Growth and M for Momentum), which combines the weighted average of the individual Style Scores into one score. This is perfectly suited for those who want their stocks to have the best scores across the board.

| | |
|----------------|---|
| Value Score | A |
| Growth Score | D |
| Momentum Score | A |
| VGM Score | A |

As an investor, you want to buy stocks with the highest probability of success. That means buying stocks with a Zacks Recommendation of Outperform, which also has a Style Score of an A or a B.

Disclosures

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