Honeywell (HON)
Analyst: Evgeniy Koup

Recommendation: HOLD **Estimated Fair Value: $45-51***

1. **Reasons for the Recommendation**

After conducting a thorough business and industry analysis, I recommend **holding** the stock. My estimated fair value for the stock is between **$45-51**. According to the calculations of fair value of the stock Honeywell is overpriced.

Honeywell is a cyclical company which has a tendency to perform well during up-markets, but also performs poorly in down-markets. The slowdown in the US economy and the global markets is a big concern for Honeywell. About 60% of the company's revenue is generated in the United States and 25% of revenue is generated in Europe. The growth of the US economy has been slow and raises a lot of concerns. The debt worries in the European nations raise a lot of fear because the countries have been taking a long time to come up with a solution to bail out the struggling nations such as Greece. Only 15% of revenue is generated in other parts of the world such as China and India. These are fast growing nations which could potentially lead to higher growth of the company if it can generate more revenue and increase its proportion of sales from these countries. Since a small percent of the company's revenue is generated in high-growth countries, Honeywell can be negatively impacted by the uncertainty and stagnant growth in developed nations which is a big concern but has done well thus far and beat analyst earnings expectations in the third quarter.

The United States is currently facing debt issues which have led to government budgetary cuts which include military and defense spending could greatly affect the performance of Honeywell and its competitors. The 2012 overseas contingency operations spending have been cut from $159 billion to $118 billion, which is a big drop. Overall, defense and military spending is taking a 5.3% cut. This is a big change because the US defense spending had grown at a 9.1% compound annual growth rate from 2001 through 2010. According to Standard & Poor's the defensive budget is beginning a decline that will most likely continue for numerous years. About 20% of Honeywell's revenue is generated by working on projects for the government. The budget cuts will have an effect on the company, but I do not believe it will be significant because it is a not a large portion of the sales and the firm is well diversified in its business units and operations.

Honeywell's biggest competitor is United Technologies (UTX) which has a bigger market share than Honeywell. United Technologies has recently proposed a deal to acquire Goodrich (GR) for $16.4 billion. This would put UTX in a better competitive position because Goodrich operates in many product segments/services as Honeywell that United Technologies has not had prior exposure to until now. If properly managed this could be a great move for UTX and can create tougher competition for Honeywell. This deal sounds like it might create some problems for Honeywell and I'm a little worried about the amount of additional competition which will be created. However, I believe Honeywell is well positioned and will be able to weather the storm and keep producing quality products.

Recently Honeywell announced a project that deals with converting forest residuals and algae into green transportation fuels. The US Department of Energy awarded the company $25 million to take on this project, which is going to take place in Hawaii. The project is scheduled to start initial production in 2012 and be fully operational in 2014. Also, Honeywell's owned Universal Oil Products has been selected to provide technology to increase production of detergents in China. This project is planned to start in 2012. The projects mentioned above will positively affect Honeywell and its Specialty Materials segment and will lead to further growth of the business segment.

At the end of August Honeywell announced that its wholly-owned subsidiary Egret Acquisition Corp. completed the tender offer for all shares of common stock of EMS Technologies Inc., which is a provider of connectivity solutions for mobile, computer, and satellite communications. This move could lead to growth of Honeywell which, with proper management, could result in increased profits. It will improve Honeywell's existing capabilities in mobile and computing technologies within its Automation and Control Solutions segment and satellite communications in its Aerospace segment. I believe this is a proper move for Honeywell and it will lead to further growth.

Honeywell has a higher P/E ratio and a higher forward P/E ratio than the median among its competitors. The profit margin and the operating margin are lower than the median of the competitors. This means the company is not as profitable and not as efficient as its competitors in the industry, but yet people are willing to pay more per dollar of earnings. When comparing the multiples to the items that they correlate with such as (P/E with Growth, P/B with ROE) the numbers were consistent with each other. If P/E was above the median, then Honeywell also had a higher growth rate to reflect that. Honeywell's P/E is currently lower than its historical P/E, however, the P/E of S&P 500 is lower than its historical average by a higher percentage. My valuation for Honeywell is $45 to $51 (overvalued) but according to the multiples the company is fairly valued to slightly overvalued.

2. Company Analysis

Honeywell is a worldwide diversified technology and manufacturing company providing aerospace products and services, sensing and security technologies, turbochargers, automotive products, specialty chemicals, electronic and advanced materials, process technology for refining and petrochemicals, and energy efficient products and solutions. (Bloomberg)

Strengths:

Honeywell presents a diverse set of product offerings and operates in four separate business segments that allow the company to mitigate risk and stay profitable even if one of the business units is underperforming. Honeywell's international exposure in Europe and high growth countries like China and India is a great benefit as most of the growth is expected to come from developing nations. Over the last five years revenue outside of the US and Europe has risen by 5% and the organization plans to continue the trend. The company's strong brand name is a great asset and people have a tendency to respect its operations and products. Honeywell is a global leader in the Aerospace business segment by developing innovative safety products, revolutionizing combat technology and constantly improving operational efficiencies. The firm possesses strong research and development capabilities, original equipment experience, and innovative technologies. Honeywell possesses environmentally-friendlier refrigerants and a strong technology position in a variety of specialty materials markets.

Weaknesses:

The United States government is a large source of income for the Aerospace / Defense product segment operations which are facing debt issues and budgetary cuts. Honeywell has a structure of a conglomerate company which can limit growth if not managed properly. The firm is subject to various federal, state, local, and foreign government requirements regulating the discharge of materials into the environment or otherwise relating to the protection of the environment which can lead to environmental violations and liabilities. Even though the start-up costs are very high in the sub-industry, Honeywell faces intense competition from companies such as: United Technologies, General Electric, and Boeing. The firm has a lower operating margin compared to the sub-industry average; however Honeywell has increased its profits in the last quarter by expanding its margins which is a step in the right direction. The organization sustained greater losses during the recession because it has less operations and contracts with the US government on defensive spending than the sub-industry average.

Opportunities:

Further expansion into high-growth markets like China and India as most of the global growth comes from these developing nations. Since Honeywell operates in a manufacturing industry, the company often has to deal with many health regulations that potentially lead to lawsuits and penalties. The firm has an opportunity to go above and beyond the standards and in order to cut down on law suit costs and build a more positive image and reputation.

Threats:

Honeywell operates in a cyclical industry and bad economic times can have a great negative impact on revenue. The company faces a lot of litigations and environmental violation fines. Since 40% of the company's revenue is generated abroad the firm must understand and follow foreign countries' regulations. Raw materials price fluctuations and the inability of key suppliers to meet quality and delivery requirements can have a negative impact. Also future growth heavily depends on the ability to develop new and innovative technologies. Any changes in legislation or government regulations can have a major impact on operations.

3. Industry Analysis

Honeywell is part of the Industrials sector which includes companies that focus on manufacture and distribution of capital goods such as: aerospace & defense, electrical equipment, industrial machinery, and construction. This sector also deals with transportation services which include the following: airlines, couriers, and road & rail. In order to get into a little more detail Honeywell is categorized with other companies that take part in a similar type of business and are included in the Aerospace & Defense Sub-Industry. This sub-industry focuses on producing civil or military aerospace and defense equipment, parts, and products.

The sub-industry seems to have quite a high market capitalization compared to the sector. The industrial's market cap is $ 44,628 billion and the sub-industry's market cap is $7,632 billion. This is a little above a 17% market capitalization of the whole sector.

The companies with the highest revenues are Boeing with $64,306 million in 2010, United Technologies Corp with $54,326 million in 2010, Northrup Grumman with $34,757 million in 2010, and Honeywell with $33,370 million in 2010.

Economies of scale play a big role in this industry. This industry requires a lot of experience and expertise which can only be gained over a long period of time. There also are very high fixed costs due to the type of equipment and machinery that is required to produce the types of products that this sub-industry deals with.

One of the main customers of the sub-industry is the US government and its defensive spending. Companies that are involved in general aviation and helicopter production. Hospitals are also a big customer of the sub-industry since it produces optical appliances and hospital medical equipment. Companies involved in car and auto parts manufacturing rely on the sub-industry for products and services.

The country's involvement in wars that are still currently taking place over- seas in countries like Iraq and Afghanistan has forced the government to spend a lot of money on military equipment. However, I'm surprised that the sub-industry did not outperform the sector with such high military spending in the past few years. The sub-industry greatly outperformed the sector from 2001 and finally slowed in 2008. Since 2008 the sub-industry has been slightly underperforming comparing to the Industrials sector.

There is room for growth and expansion in the sub-industry. China's five year plan mentioned an expansion in the airline industry. The country is planning on building 55 airports from 2011 through 2015. A total of 33 airports were built from 2005 to 2010; there are currently 175 airports in China and that number will increase to more than 230 by the end of 2015. This also means that many airplanes are going to be ordered and built during this period of time and as of right now this number is estimated to be 700. It is forecasted that the airline traffic will grow at an annual rate of 13% during this period of time.

According to Standard & Poor's there are two primary reasons that are driving demand for aircraft. The first is the emerging markets of Asia, Middle East, Eastern Europe, and Latin America. Many airlines in these parts of the world have remained profitable as the demand for air travel increases. The second reason is the replacement of older versions of airplanes that are not as fuel efficient as the newer models. Fuel prices have been increasing as of late and have hit a pretty high plateau. The US and Western Europe have the largest fleets, but they are also the oldest fleets and therefore demand has begun to improve as these countries are looking to replace their older models of planes with more fuel-efficient ones.

Considering the reasons mentioned above I have a **moderately bullish** outlook for the sub-industry.

*Methodology

The estimated fair value of Honeywell ranging between $45 and $51 was calculated by using the dividend discount model. The annual nominal growth rates ranged between 5.71% and 11.30%. The stable growth rate of 5.71% was calculated by GDP growth estimates of the countries that Honeywell operates in. The GDP growth rates were weighted depending on how much of the total revenue is generated in a certain nation. The high and transition growth rates were calculated using scenario analysis and were based on global economic and Aerospace and Defense sub-industry outlooks. The calculated dividends were then discounted by the calculated cost of equity of the company.

Appendix: Multiples

Comparable Firms

Firms	P/E(ttm)	Forward P/E	PEG Ratio	P/B	P/S	EV/EBITDA	EV/Sales	Growth	ROE	Profit Margin	Operating Margin
United Technologies (UTX)	14.51	13.09	1.22	3.12	1.21	7.52	1.31	11.74%	22.39%	8.35%	15.02%
The Boeing Company (BA)	12.94	13.24	1.11	8.19	0.74	7.74	0.79	13.48%	71.42%	5.76%	7.68%
Goodrich Corporation (GR)	21.72	17.79	1.31	4.04	1.98	11.26	2.22	15.64%	20.27%	9.32%	15.80%
Esterline Tech Corp. (ESL)	10.23	10.01	0.84	1.10	1.07	8.34	1.60	14.00%	11.14%	10.53%	14.73%
General Electric Company (GE)	12.34	10.30	0.94	1.39	1.15	15.82	3.32	13.00%	11.80%	9.89%	13.59%
General Dynamics Corp. (GD)	8.90	8.36	1.21	1.66	0.70	5.56	0.78	7.25%	19.69%	8.25%	12.30%
Triumph Group Inc. (TGI)	13.98	11.23	0.91	1.67	0.84	7.94	1.21	14.20%	13.19%	6.11%	12.26%
HEICO Corporation (HEI)	35.05	30.21	2.11	4.61	3.36	16.11	3.32	16.50%	14.34%	9.64%	18.21%
Moog Inc. (MOG.A)	13.46	11.72	1.21	1.38	0.77	7.61	1.04	10.80%	10.90%	5.70%	9.56%
Rockwell Collings, Inc. (COL)	13.41	10.85	0.99	5.53	1.76	8.10	1.76	12.46%	40.81%	13.19%	18.75%
Honeywell (HON)	**15.37**	**12.01**	**0.83**	**3.58**	**1.13**	**9.49**	**1.23**	**16.13%**	**23.34%**	**7.46%**	**10.37%**
Average	15.63	13.53	1.15	3.30	1.34	9.59	1.69	13.20%	23.57%	8.56%	13.48%
Difference	-0.26	-1.52	-0.32	0.28	-0.21	-0.10	-0.46	2.93%	-0.23%	-1.10%	-3.11%
Median	13.46	11.72	1.11	3.12	1.13	8.1	1.31	13.48%	19.69%	8.35%	13.59%
Difference	1.91	0.29	-0.28	0.46	0	1.39	-0.08	2.65%	3.65%	-0.89%	-3.22%

Sources: Google Finance and Yahoo! Finance

**growth rates are average growth rates from analysts covering the stock. The growth rate used in the DCF are based on fundamental growth rates.*

Historical multiples

P/E											
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	TTM
Honeywell	N/A	N/A	21.4	23.8	20.0	18.0	19.5	8.7	13.8	20.5	16.4
S&P 500	23.2	19.7	21.1	19.2	17.2	16.8	16.5	10.9	18.6	15.5	13.8
P/B											
Honeywell	3.0	2.2	2.7	2.7	2.8	3.8	5.0	3.3	3.4	3.9	3.6
S&P 500	3.3	2.5	3.1	3.1	2.9	2.9	2.7	1.7	2.2	2.2	2.0
P/S											
Honeywelll	1.2	0.9	1.2	1.2	1.1	1.2	1.4	0.7	1.0	1.2	1.2
S&P 500	1.5	1.3	1.6	1.6	1.5	1.6	1.5	0.9	1.2	1.3	1.2

Source: Morningstar, Inc.