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HEARD ON THE STREET

Boeing's Upside? Not Much Downside Is Left for the Shares

TURBULENCE

Boeing CEO Condit Resigns in Shake-Up at Aerospace Titan[2]

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There isn't much good to say about **Boeing** Co. these days.

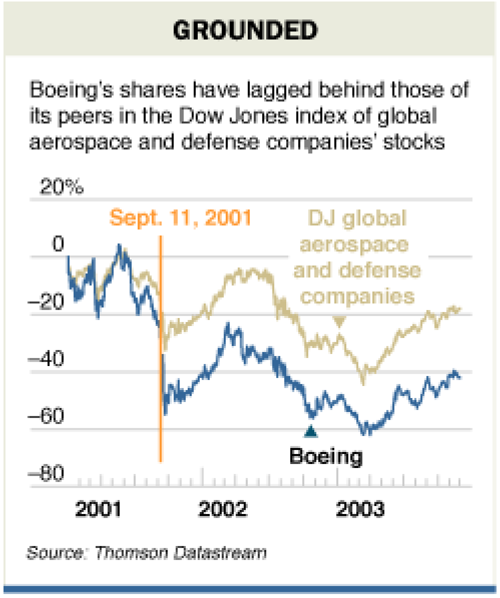
The chief executive and finance chief resigned within a week of each other amid a scandal that threatens to engulf half of the Chicago company's business. The other half, Boeing's commercial-aircraft operations, is in even worse shape. (See related article[1].)

But at a time when the business couldn't seem gloomier, a number of successful investors and analysts are betting that this is as bad as it gets. Their argument: At some point -- and that point could be months or even years away -- a rejuvenated airline industry will be racing to keep up with demand, and will turn to Boeing for hundreds of aircraft orders.

As that happens, Boeing shares will soar. "The investment thesis was going to play out regardless of who is leading the company," says Richard Turgeon, director of research at Victory Capital Management in Cleveland.

Investors who are bullish on Boeing greeted Monday's resignation of Chairman and CEO Phil Condit with restrained praise, as did the market, which drove Boeing shares down just 1%, or 37 cents, to $38.02 in 4 p.m. New York Stock Exchange trading. Investors have long criticized Mr. Condit for overpaying for acquisitions, including his $3.75 billion purchase of the satellite business of Hughes Electronics. The company has now written off two-thirds of that purchase price. "The investment community often cringed every time Boeing said it was close to making an acquisition," Mr. Turgeon says. "What happens is they make an acquisition and then 12 to 18 months later they take a charge because they overpaid for the acquisition."

Mr. Condit's successor, Harry Stonecipher, the former head of McDonnell Douglas, who will be president and chief executive, won praise for his nuts-and-bolts management style and smart allocation of capital, which is particularly crucial for a company that generates billions of dollars in free cash flow each year.



Mr. Turgeon, who has followed Boeing for 10 years, says that if the travel business continues to pick up, Boeing's shares will react. "From a sentiment point of view, once the travel market picks up, the stock will improve," he says. "That's how you play this stock."

The investment case for Boeing isn't much more complex than that. The company has just one competitor, in Airbus, and, over time, demand for air travel and therefore aircraft will continue to rise. That means airlines will have to buy more Boeing jets.

Shares of Boeing, long an American business icon and still the country's largest exporter, have never really recovered from the downturn that followed the Sept. 11, 2001, terror attacks. The shares hit a fresh low this spring on fears that the looming war in Iraq and the epidemic of severe acute respiratory syndrome would further delay any rebound in air travel. Layered on to that was the long-running scandal involving stolen documents from Lockheed Martin Corp.

Boeing shares bottomed in March in the mid-$20s, a price that essentially said that earnings would never grow again. Soon after, Robert Friedman, an aerospace analyst at Standard & Poor's, upgraded the stock to "buy." "What happened was a once-in-a-decade event in terms of that stock price," Mr. Friedman says. Now, with the stock up 50% from its low, he says he still believes the shares are cheap, saying that is why the latest round of bad news hasn't pushed them lower.

"Even in the worst environment, in the worst downturn in the commercial-aircraft business, the company still generates over $2 billion in free cash flow," Mr. Friedman says.

Even with the current scandal, things could be worse for Boeing. In the early 1990s, before it expanded into defense, commercial aircraft accounted for 80% of Boeing's revenue. Now defense and commercial aircraft each make up about 50% of revenue. Defense, which was supposed to bolster the stock in a downturn, has weighed on the shares as investors worried that Boeing's misdeeds might anger the government, by far the company's biggest customer.

Mr. Stonecipher's presence at the helm should ease some of those concerns, given his experience running a defense contractor. His appointment also gave some comfort to investors, who are anxiously awaiting a decision by Boeing's board on whether to proceed with a proposed superefficient jetliner program dubbed the 7E7 Dreamliner. On the one hand, it could be a huge seller for Boeing. But the project also will be costly and could mean a big hit to the company's free cash flow. Mr. Stonecipher calmed fears Monday, saying he wouldn't favor the program if costs weren't substantially below those of any jet Boeing builds today.

Richard Pzena, president of Pzena Investment Management LLC, a New York money manager with $4 billion in assets, began buying Boeing over the summer and the stock is now its largest holding. He points out that most so-called cyclical stocks, which rise and fall with the economy, have soared in anticipation of the economic rebound now under way. But Boeing shares remain cheap.

He says no one, including many Wall Street analysts, is accounting for the inevitable rebound and the operating leverage that can boost earnings. Last year, Boeing earned $2.84 a share, and this year, analysts expect that number to fall to 96 cents, according to Reuters Research. Analysts and the company expect earnings to roughly double next year, putting the stock's valuation in line with the overall market. Nothing, in other words, to get too excited about.

But that ignores the fact that Boeing will deliver 279 commercial airliners this year, down from 620 in 1999, according to Merrill Lynch. So it isn't unreasonable to assume revenue can double when the market rebounds. That would allow Boeing to spread its big fixed costs among more jets, potentially doubling profit margins. By Mr. Pzena's calculations, that means Boeing could earn $5 a share at the midpoint of any rebound. That means Boeing's stock is trading at 7.6 times those earnings, making it one of the cheapest brand-name stocks in the market.

Critics don't buy these arguments, pointing to deserts filled with mothballed airplanes and stepped-up competition from Airbus, as reasons why Boeing shares will languish. They add that the airline industry's financial problems are far deeper than they have been in the past. Finally, even the bulls acknowledge that Boeing's businesses will never be fast growers, but instead should be owned for the cyclical rebound.

But Mr. Pzena contends that while there are a lot of idle planes in the desert, many are old models that will never fly again. He also says there is a basic difference between Boeing and Airbus that will benefit Boeing during a rebound. Airbus has a tough time cutting costs during a downturn because European work rules make it hard to lay off workers, so the company doesn't ramp up production during the boom and instead builds up a big backlog. Boeing is willing to ramp up production, so when the next rebound occurs, it will be able to offer a quicker delivery for its customers. "Boeing should get a disproportionate share of the business because they can deliver," Mr. Pzena says.

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