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***Studies in Applied Finance***

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**INVESTMENT THESIS FOR  
HONEYWELL INTERNATIONAL,  
INC. (NYSE: HON)**

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***Charles Jie***

Johns Hopkins Institute for Applied Economics,  
Global Health, and Study of Business Enterprise



## **Investment Thesis for Honeywell International, Inc. (NYSE: HON)**

By Charles Jie

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### **About the Series**

The Studies in Applied Finance series is under the general direction of Professor Steve H. Hanke, Co-Director of the Johns Hopkins Institute for Applied Economics, Global Health, and Study of Business Enterprise ([hanke@jhu.edu](mailto:hanke@jhu.edu)) and Dr. Hesam Motlagh ([hnekoor1@jhu.edu](mailto:hnekoor1@jhu.edu)), a Fellow at the Johns Hopkins Institute for Applied Economics, Global Health, and Study of Business Enterprise.

This working paper is one in a series on applied financial economics, which focuses on company valuations. The authors are mainly students at the Johns Hopkins University in Baltimore who have conducted their work at the Institute as undergraduate researchers.

### **About the Author**

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### **Summary**

This working paper is an in-depth analysis of Honeywell International Inc. Our analysis examines the economic factors that impact Honeywell's underlying business and how Honeywell has adapted to these ever-changing factors. This economic analysis is then combined with our proprietary, Hanke-Guttridge Discounted Cash Flow (HG-DCF) model to determine Honeywell's financial position. The HG-DCF model will be presented along-side Monte-Carlo simulations to reveal the distribution of probable free cash flows and the likelihood of future earnings. In addition to these quantitative factors, we also examine the compensation plans of Honeywell's executives to assess alignment with shareholders. At the conclusion of this analysis, it is our intention for readers to understand Honeywell's business plan and the company's financial standing to arrive at a sound investment decision.

### **Acknowledgements**

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Keywords: Financial Modelling, Honeywell International, Discounted Cash Flow, Free Cash Flow, Monte-Carlo Simulation, Investment Thesis, Management Compensation.



**Rating – Buy – Avg. Free Cash Flow per Share: \$126**

<b>Company Name</b>	Honeywell
<b>Date</b>	5/11/2016
<b>FY End</b>	12/31/2015
<b>Current Price</b>	\$114.11
<b>52W High</b>	\$116.56
<b>52W Low</b>	\$87.00
<b>Market Cap</b>	88.12 Billion
<b>Enterprise value</b>	88.12 Billion
<b>Total Debt</b>	9.70 Billion
<b>Cash</b>	4.47 Billion
<b>Net Debt/EV</b>	5.57%
<b>Dividend Yield</b>	2.09%
<b>Diluted Shares Outstanding</b>	762.12M
<b>Current P/E</b>	18.93x
<b>2018 P/E (EPS*)</b>	12.16 (\$9.38)
<b>2017 P/E (EPS*)</b>	13.74 (\$8.30)
<b>2016 P/E (EPS*)</b>	15.71 (\$7.26)
<b>2015 EPS</b>	\$6.11
<b>2014 EPS</b>	\$5.40
<b>2013 EPS</b>	\$4.99

\*Consensus estimates as of the time of this writing. Source: Bloomberg Terminal

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## Executive Summary:

Honeywell International, Inc. (NYSE:HON) operates in the aerospace, automated sensory systems, and chemical refining/processing technologies sectors. By utilizing historical averages, management guidance, and the macro outlook for Honeywell's end markets, our Hanke-Guttridge Discounted Free Cash Flow (HG-DCF) model has determined that the normalized probable free cash flow per share is \$125.74, compared to the current market price of \$114.11 per share. This includes margin expansion from both aerospace and automated control systems (ACS) segments due to strong end markets and Elster integration synergies, which will offset some of performance technologies (PMT)'s revenue headwinds from the global industrial slowdown and fall in oil-related capital expenditures ("capex"). Even as the PMT segment struggles with lower commodity prices, its main sub-segment universal oil products (UOP) franchise retains a strong medium to long run outlook as its best-in-industry residual oil refining technology Uniflex continues to secure contract wins, Chinese capex spending to become self-sufficient in major chemical feedstocks comes online, and natural gas processing grows with wider utilization of global natural gas deposits. Additionally, management is incentivized through a compensation plan based on both financial performance and shareholder returns, which has resulted in a very disciplined and consistent track record of margin expansion and mergers & acquisition (M&A) strategy. Given the relatively unjustified doubts on the health of the PMT industrial segment and a solid management team with a proven record of success, I rate **Honeywell** a **BUY**.

## **Catalysts and Risks:**

- Robust fleet delivery outlook for the global commercial aerospace market.
- Recovery in military budgets in the US and abroad (military aero).
- Bottom of the barrel upgrading (residual oil refining) Uniflex technology contract wins.
- U.S. and global construction market health.
- PDH and MTO (UOP segment) contract wins driven by the Propylene and Ethylene supply and demand imbalance in China.
- Peak refining cycle and volatile oil/gas prices may slow equipment sales over the next decade.
- The effects of M&A integration on margins.
- Foreign exchange costs.

## **Company Description and Historical Performance:**

Honeywell International, based in Morristown, NJ, is a multinational industrial company that operates in the broad commercial and military aerospace, automated sensory systems, and chemical processing & refining technologies markets. Originally founded in 1906 as a heating system producer, Honeywell became a diversified conglomerate over the 20<sup>th</sup> century with the acquisition of Sperry Aerospace in 1986 and Honeywell's own sale to fellow industrials peer AlliedSignal in 1999.

With revenues of \$38 billion in 2015 and a current market cap of over \$83 billion, Honeywell is one of the largest diversified industrials company in the world, and is therefore included in the Standard & Poor's (S&P) 500 index. Honeywell is also held by 86 Exchange Traded Funds (ETFs), which account for 2.3% of total shares outstanding. The largest ETF holdings are the SPDR S&P 500 ETF (1.0% of shares outstanding), the iShares Core S&P 500 ETF (0.4% of shares outstanding), the Industrial Select Sector SPDR Fund (0.4% of shares outstanding), and the iShares Russell 1000 Growth ETF (0.3% of shares outstanding).

### **Business Segments**

The company consists of three segments: Aerospace, Automation and Control Systems (ACS), and Performance Materials and Technologies (PMT). Looking ahead, the company should continue its recent track record of margin expansion due to its reliance on strong end markets for future growth. The aerospace segment, driven by commercial and military sales, will experience tailwinds from a pickup in military spending across the globe, as well as continued strength in the commercial end market. ACS will continue to experience top line growth thanks to stronger-than expected construction markets as well as the integration of Elster and other acquisitions. Finally, despite struggling due to the recent industrial slowdown and fall in oil prices, PMT sales will likely trough in the next year before recovering due to petrochemical capex from China coming online and increased US natural gas production.

The company's largest segment, Aerospace, made up 39.5% of total revenues in 2015, and is comprised of 4 sub-segments: Commercial Original Equipment (OE), Commercial Aftermarket, Defense & Space, and Transportation Systems. Commercial OE is effectively Honeywell's in-house original equipment manufacturing business which sells directly to aircraft manufacturers and commercial aircraft operators like airlines for new fleet deliveries. Conversely, the commercial aftermarket segment is the original equipment manufacturing (OEM) business that targets the maintenance aftermarket for aircraft operators. While the OE segment is expected to suffer revenue declines over the next year or two as the

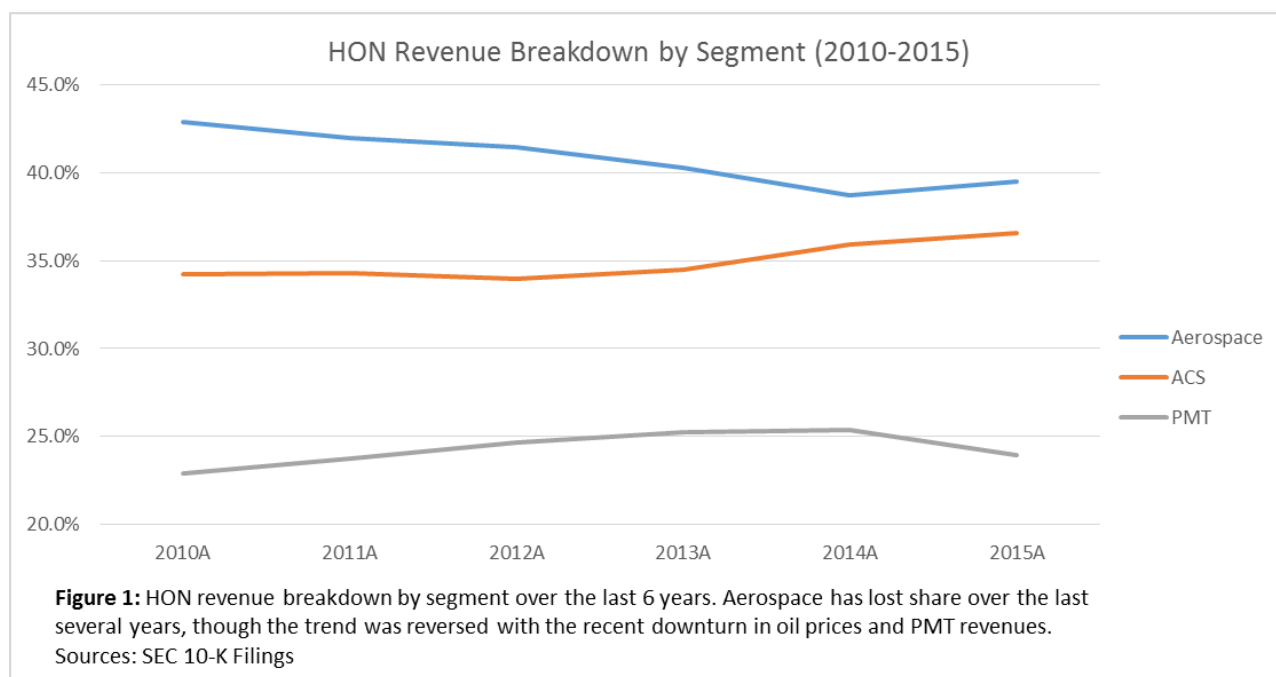
company offers discounts and incentives to secure new major contract wins from airlines, this is expected to provide a significant boost to aftermarket sales down the road. With strong commentary from Boeing and Airbus on commercial order books and deliveries, this half of Honeywell's aerospace segment is expected to deliver strong results going forward. The defense sub-segment mainly provides physical parts and electronic systems both as original equipment and through maintenance services to national military forces across the globe. Following several years of secular decline in military spending across the board in many countries, the defense cycle seems to have bottomed out and military spending should recover both globally and in the U.S. This segment also accounted for a majority of the firm's sales to the US government, which totaled \$3.7 billion in 2015. Of that total, \$2.7 billion came from the Department of Defense. Finally, the transportation systems sub-segment consists of OEM parts and services for automotive and trucking manufacturers, and despite recent macro headwinds, the sub-segment should return to positive growth with <10% China exposure in its sales.<sup>1</sup> Honeywell's main competitors in the aerospace and defense market are General Electric, Rockwell Collins, Thales, and United Technologies. In the transportation market, it mainly competes with Borg Warner.

The company's second largest segment, Automation and Control Systems (ACS), made up 36.6% of total revenues in 2015 and contains two sub-segments: Energy Safety & Security (ESS) as well as Building Solutions & Distribution. Energy Safety & Security is the sub-segment that produces residential smart security and fire sensing systems, smart meters (utilities), industrial safety products and systems (gas detection, scanning equipment, etc.), and commercial building security, refrigeration, and fire detection systems. ESS made up almost 3/4ths of ACS revenues in 2015. The remainder, Building Solutions & Distribution, consists of the distribution of ESS products as well as the software solutions services that integrates ACS products with a SaaS-type business model. ACS is mainly driven by construction end markets, with 44% from commercial, 34% from industrial, and 22% from residential end markets. Despite the recent slowdown in 2015, the integration of Elster in Q1 2016 is expected to add a \$1.5 billion portfolio to the segment and make HON a leader in the global meter and smart meter markets, which have industry compound annual growth rates (CAGR) of 8% and 13%, respectively. This integration is also expected to add 8% cost synergies and contribute to the company's goals of reaching 22-23% operating margins by 2020. Through a strategy of M&A, Honeywell has been able to grow the ACS segment significantly in the recent past (see figure 1), a trend management has emphasized on continuing in the near future as ESS has become the largest sub-segment in the company's portfolio (see figure 1a). The company's main competitors in ACS end markets are 3M, Johnson Controls, Schneider, Siemens, and Zebra-Motorola.

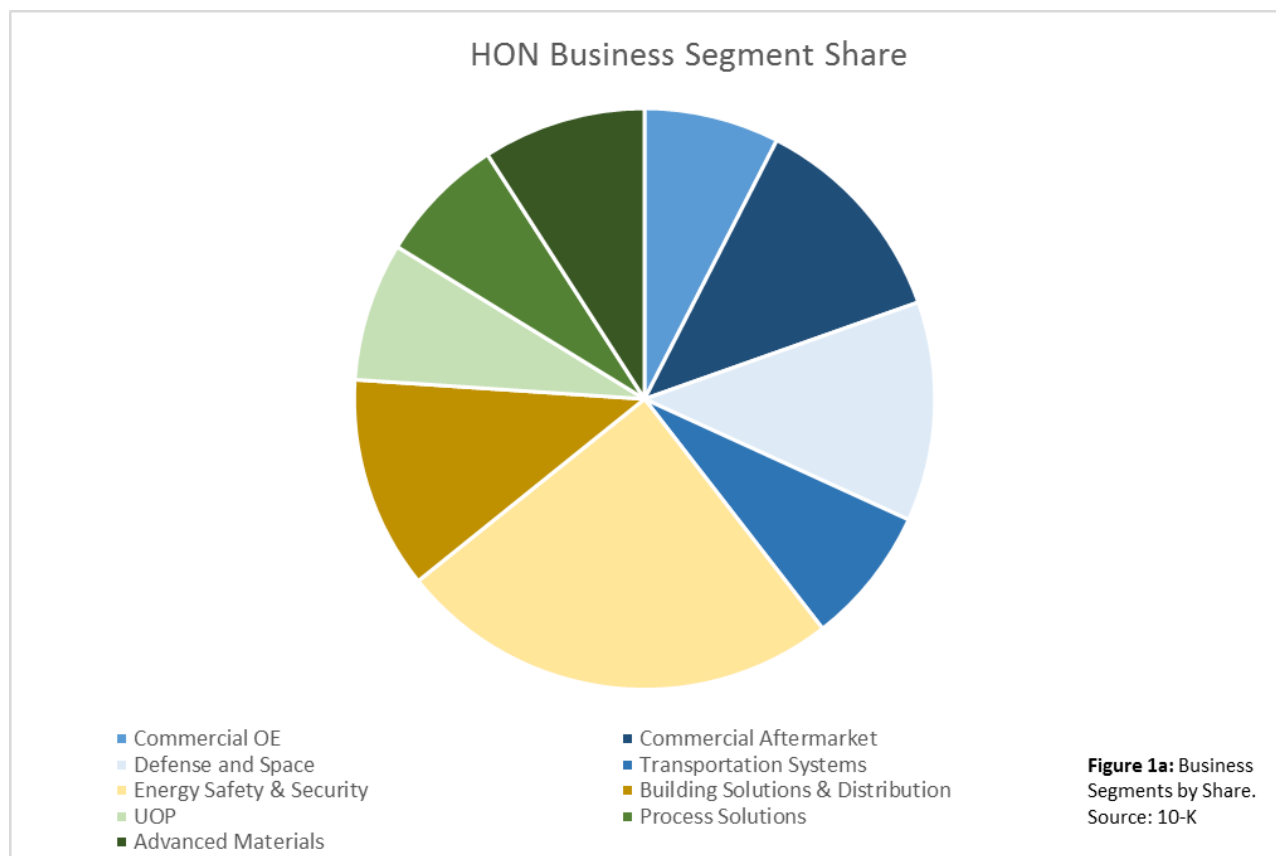
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<sup>1</sup> JPM Segment ER Reports: September 22, 2015 and June 8, 2015

**Figure 1: Honeywell's Revenues by Business Segment (2010-2015)**



**Figure 1a: Honeywell Revenue Breakdown by Business Sub-segment, 2015**



Finally, the company's third segment, Performance Materials and Technologies, made up 23.9% of 2015 revenues and contains 3 sub-segments: Universal Oil Products (UOP), Process Solutions, and Advanced Materials. UOP provides process technology, products (catalysts and absorbents), equipment, and consulting services to the oil processing and refining industries. This segment has suffered a significant contraction in revenue due to the fall in oil prices in 2015, and is expected to contract again in 2016 and 2017. As refineries are at peak cycle with low input prices and a capacity glut, future growth from new capital expenditures from this end market will slow, to be offset by natural gas processing and the Chinese initiative to become self-sufficient on major chemical feedstocks through MTO (methanol to olefin) and PDH (propane dehydrogenation) projects. Process Solutions offers automation control, instrumentation, services, and advanced software for the oil & gas, refining, paper, industrial power generation, chemicals, life sciences, metals, and mining industries. Advanced Materials manufactures a wide variety of high-performance products like fluorocarbons, resins, fertilizers, phenol, waxes, additives, etc.<sup>2</sup> These other two sub-segments are expected to deliver consistent low to mid-single digit growth as The company's main competitors in its PMT end markets are Albemarle (specialty chemicals), BASF (plastics and resins), Dow (plastics, petrochemicals, energy infrastructure, and specialty chemicals), Dupont (petrochemicals, specialty chemicals, plastics), Emerson (refining, upstream, petrochemicals), and Sinopec (upstream, midstream, refining, petrochemicals).

### Historical performance

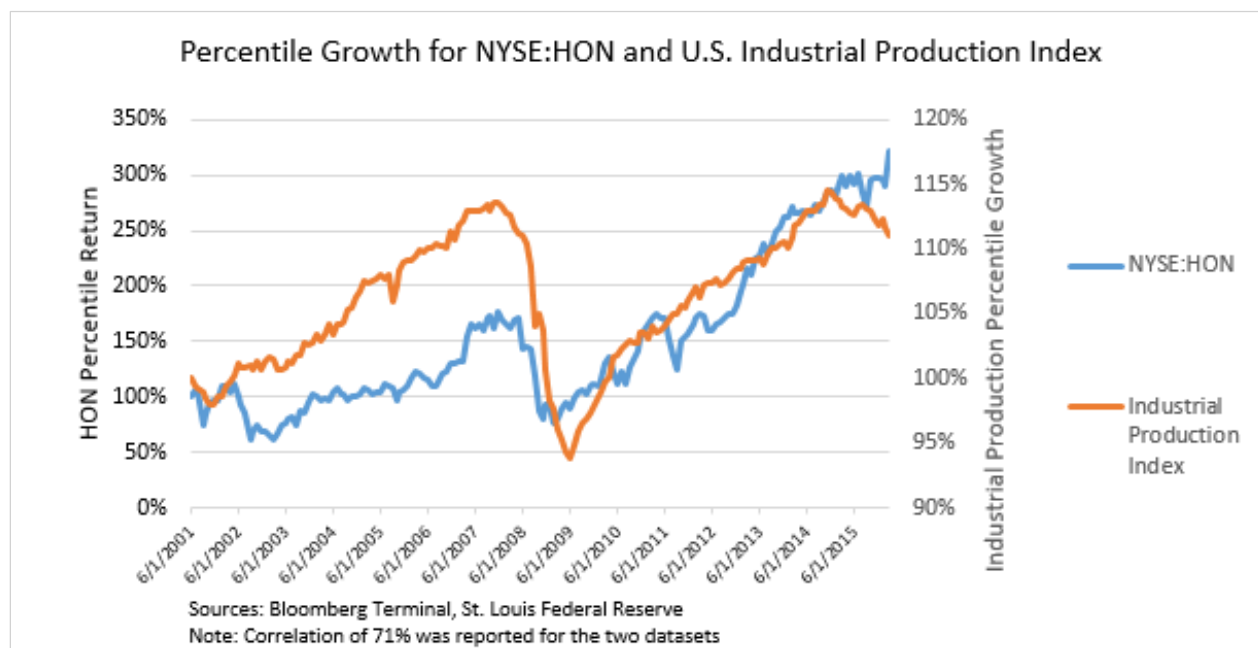
The Company has largely maintained a consistent history of positive returns over the last 5 years, with a CAGR of +14.9% and a total return of 100.84%. Going back to 2001, Honeywell's returns have been directionally correlated with industrial production in the United States due to its high exposure to aerospace, defense, energy, and construction (figure 2), despite the difference in magnitude (Honeywell gained 175% vs. industrial index's 9.3%). While industrial production is expected to be flat through the first half of 2016 due to volatility surrounding energy prices, a strong dollar, and excess inventories, industry groups have forecasted a 3% bounce back in manufacturing activity for the second half of 2016 and 2.5% growth through 2018. HON has outperformed both the S&P 500 and the Vanguard Industrials sector ETF over the last 6 months, last year, and the last 5 years. Honeywell has also outperformed many of its industrial peers over the 15 year time period due to its broadly diversified business segments and its effective M&A strategy driving margin expansion (figure 2a) Currently, 17 analysts have a buy rating and 5 have a hold rating, with an average target price of \$124.47, implying a 9.1% upside to the stock (Source: Bloomberg Terminal, Function <ANR>). The dividend has increased from \$1.33 in 2011 to \$2.15 in 2015, an increase of 61%.

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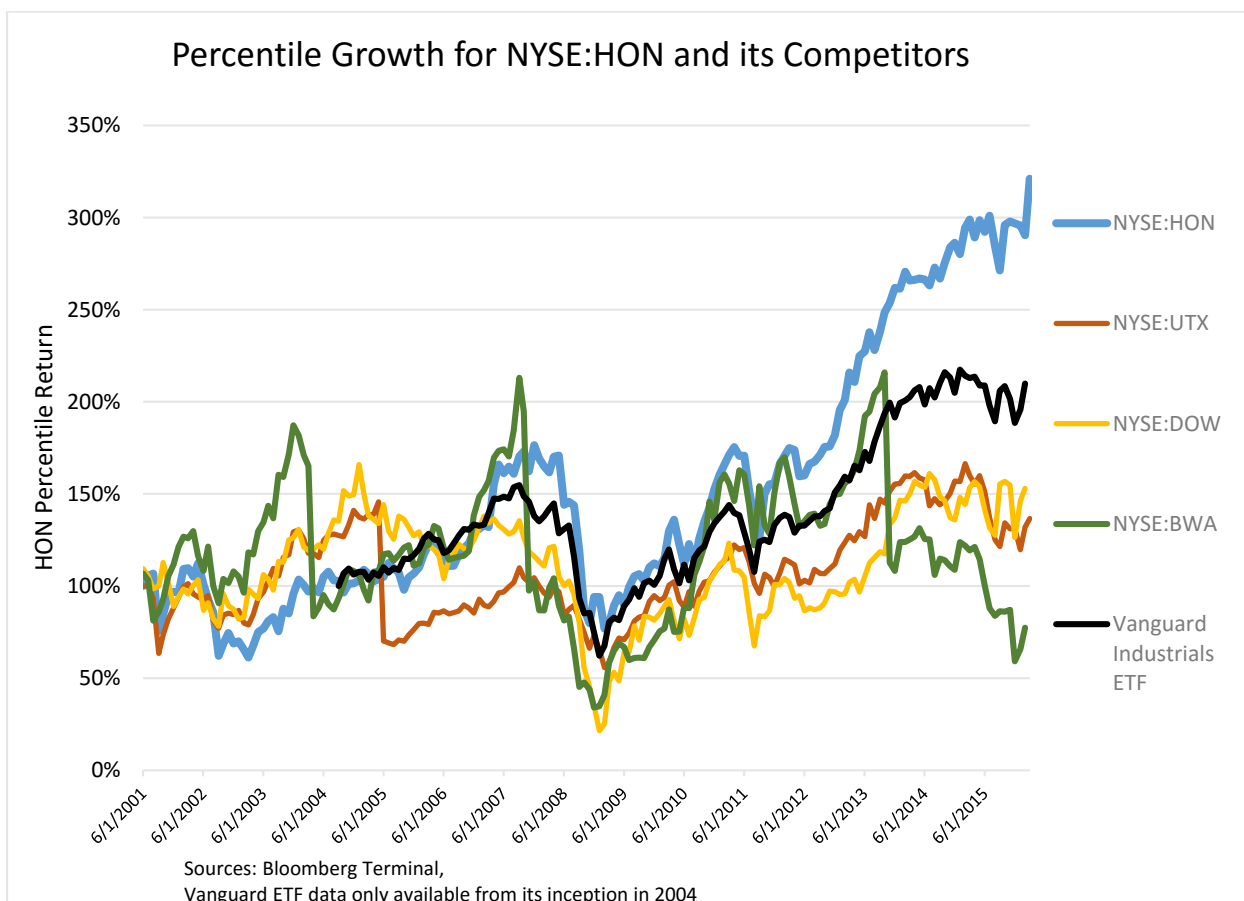
<sup>2</sup> JPM ER Report –segment specific (June 8 2015)



**Figure 2: Percentile Growth for Honeywell Stock and U.S. Industrial Production Index**

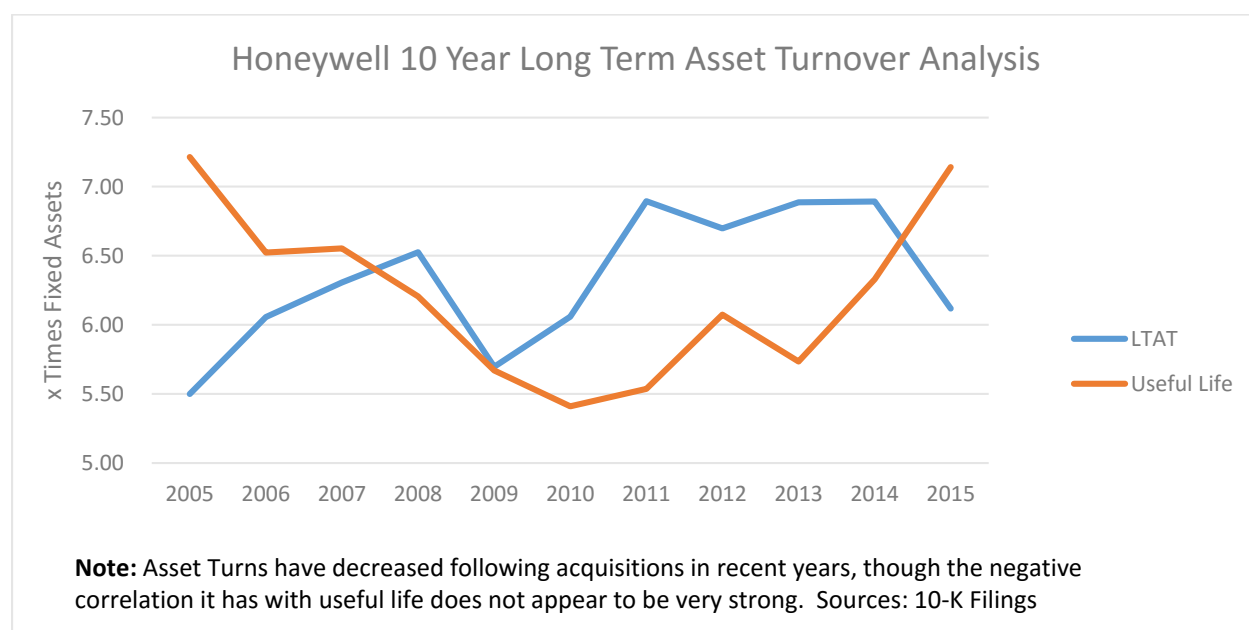


**Figure 2a: Honeywell versus its Industrials Peers**



When a long-term asset turnover (LTAT) analysis is applied to the company's historical financial results, the results are interesting. Usually in a range between 5.5 and 7, long-term asset turnover has decreased with the major acquisition of Elster (\$5.1 billion) in 2015, but not for the other smaller bolt-on acquisitions over the time period (figure 3). In fact, the only other noticeable decrease in LTAT appears to be linked to the economic recession in 2008 more so than the effects of capital allocation. This could potentially be explained by management's conservative attitudes towards acquisitions. Excluding the Elster deal, most other acquisitions have been around \$1 billion or less in size and were done with the purpose of complementing an existing business segment (as a "bolt-on") rather than bring in revenue streams from completely new end markets. These kinds of deals are typically accretive (beneficial) to margins due to them being easier to integrate over a shorter period of time. As such, asset productivity is not likely to be significantly decreased from the type of small acquisitions Honeywell has pursued in the past. Going forward, LTAT is optimistically projected to reach 10.3 in the long run normalized period, 44% higher than the figure in 2015, based on confidence in continued management execution with regards to both M&A and organic growth, a strong balance sheet, and strong end markets.

**Figure 3: Honeywell Asset Turns vs. Useful Life (2005-2015)**



## Model Assumptions:

The HG-DCF for this analysis was built as described in lectures with a few adjustments. Revenue was projected on an operating segment and sub-segment basis rather than a geographic one. This is because industry-specific drivers will tend to have a bigger influence on future results than purely geographic drivers due to the strong relationship between segment results and end markets (i.e. UOP to refining and oil exploration capex, ACS to construction activity, etc.). Margins were forecasted to further expand beyond 23% in the normalized period, which matches the company's 5 year margin goal of 23% by 2020.

### Balance Sheet and Income Statement Trends

*The results are contained in the 'Balance Sheet' and 'Income Statement' tabs of the accompanying spreadsheet.*

While transferring the balance sheet and income statement data, the \$5.1 billion acquisition of Elster in 4Q 2015 clearly stood out on both the goodwill line item in the balance sheet as well as the cash line. Goodwill has fluctuated in recent years, decreasing slightly in 2014 with the divestiture of the Friction Materials business and increasing in 2013 with the \$1.3B acquisition of Intermec and RAE. This again reflects management's conservative stance towards M&A, as a majority of past acquisitions have been wholly funded by cash as opposed to debt. Honeywell's failed \$90 billion takeover attempt of United Technologies (NYSE:UTX) in February 2016, which would have been built on \$36 billion of new debt issuances, was certainly an exception. However, CEO David Cote made clear in an investor meeting following withdrawing his bid for UTX that Honeywell would return to stick to smaller acquisitions in the future, something that has been taken into account for the capital expenditures input in the model.

### Value Drivers (HG-CF Tab)

*The results are contained in the 'HG-CF' tab of the accompanying spreadsheet.*

The value drivers tab shows a consistent history of margin expansion across Cost of Products, Cost of Services, as well as selling, general, and administrative (SG&A) expenses, with EBITDA margin drifting up from 12% in 2010 to 20% in 2015, despite a slowdown in top-line growth in recent years. The normalized EBITDA margin forecast of 25.6% was derived by adding depreciation as a share of revenues (~ 2.6%) to the company's own long term operating margin goal of 23%. The adjustment for depreciation was needed in order to accurately reflect the actual cash position of the company for the purposes of the DCF. In order to more accurately capture capex, 7 years instead of 5 years of capex as % of revenue was calculated in order to more accurately capture HON's track record of frequent bolt-on acquisitions.

Sub-segment revenue growth rates were modeled separately, which resulted in a blended revenue CAGR of 5.47% in the DCF. Commercial OE was forecasted to grow at 10% (above average) in the normalized period to reflect a strong aerospace outlook and management initiatives to secure more contract wins. The aftermarket segment was only forecasted to grow at 5% (below average) in order to reflect poor recent performance (excluding 2011, the average is only 3.7%). Aftermarket sales should pick up down the road as a result of strong Commercial OE sales over the next few years, which is why this input is higher than the 4 year average. Defense is forecasted to grow at 3.0% (above -2.6% average) in order to reflect a pickup in the defense spending cycle, and Transportation Systems is forecasted to grow at 5% (above -0.6% average), which is an adjusted average (excluding 2015 results –macro headwinds and a divestiture).

In ACS, ESS was modeled to grow at 6% (below 7% average) since several hundred basis point of improvement in 2015 came from the Elster acquisition, as well as to reflect potential risks in the construction end market. Building Solutions and Distribution was modeled to grow at 3% in order to reflect the company's initiatives in HOS Gold (SaaS) and the integration of Elster's meter platform into the company's wider integrated software platform.

For PMT, UOP was forecasted to grow at 10% in the normalized period (below average) in order to reflect the company's strong petrochemicals end market (which should offset any weaknesses going

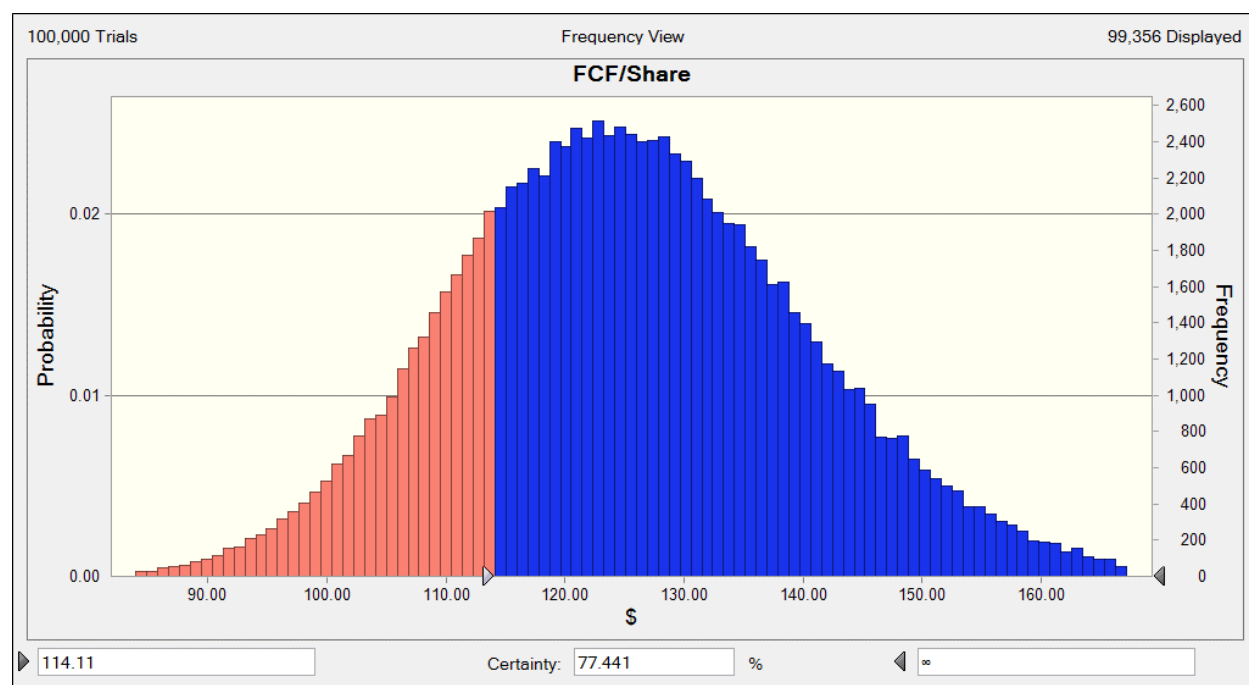
forward in the downstream refining end market) as well as the company's exposure to the natural gas boom. Due to the tailwinds from the shale boom in 2011-2013, however, the input rate was lowered from the average since an event of that magnitude was likely a one-time event. Process Solutions was modeled to grow at 3% (above average) in order to exclude the impact of the onetime plummet in oil prices going forward into the normalized period (rather assuming oil stabilizing in the medium run). Advanced Materials was modeled to grow at 5% in order to reflect management's interest in future bolt-on acquisitions in this sector as well as its exposure to late-cycle refining end markets whose impact on revenue has not occurred yet.

EBITDA margins were assumed to expand to 25.6%, which is the top end of management's long term operating margin guidance range (22-23%) plus the adjustment for depreciation and amortization (2.6%). Capex was assumed to be the historical average as management should maintain its conservative yet effective M&A strategy after the failed UTX bid. Tax expense was scaled up above average levels to 23.5% of EBITDA in the normalized period to reflect the increased profitability that would come hand in hand with margin expansion. Historical averages were used for other variables (like interest).

## Model Results:

The free cash flow per share obtained from these assumptions is \$125.74 versus the current price of \$114.11 yielding a potential 10.2% upside. When the values described above are incorporated into the model, the LTAT breaches their historical range by attaining 10.3 in 2025, almost 1.4 times the historical range of 5-7.5. In order to achieve this kind of result, Honeywell would have to successfully execute on its 5 year plan of margin expansion in addition to continued top line growth through a conservative M&A strategy. To assess how well-determined this forecasted value is, we performed a Monte-Carlo (MC) Simulation (figure 4).

**Figure 4. Monte Carlo Distribution of FCF Per Share for Honeywell**



The current price (when the MC was performed) falls in the 23<sup>rd</sup> percentile of the simulation (Fig. 3), which indicates that there is an approximately 77% chance of long term free cash flow per share exceeding today's market price. Essentially, this quantitative analysis implies that Honeywell could have some value as an investment opportunity. Due to the usage of a combination of research and company estimates for 2016 (and lower STD assigned for those values), the MC is not a pure normal distribution, but rather one adjusted for forecasts in the short-term that have higher degrees of certainty.

Therefore at this point, devoid of management compensation we would rate the stock a weak buy mainly due to the company's strong end markets that will drive continued top line growth as commodity prices stabilize. To achieve today's stock price revenue assumptions for any sub-segment only has to be tapered down by a few hundred basis points, or for the normalized EBITDA margin to decrease by 100 bps.

## Qualitative Analysis:

### Management Compensation

The compensation committee approves all compensation programs for Honeywell and named executives and the independent directors of the board. In 2015, the main components of the executive compensation plan were a cash base salary, a short-term cash incentive award based on performance metrics, annual stock options, and a long term equity growth plan (figure 5; Source: SEC Filings DEF-14A).

**Figure 5: Management Compensation Breakdown**

NEO	Position	Base Salary	Annual Bonus	Annual Stock Options	Annualized Growth Plan <sup>(A)</sup>	Annual Direct Compensation <sup>(B)</sup>
David M. Cote	CEO	\$1,890,000	\$5,700,000	\$10,338,000	\$7,125,000	\$25,053,000
Thomas A. Szlosek	CFO	\$829,077	\$850,000	\$2,153,750	\$1,500,000	\$5,332,827
Roger Fradin	Vice-Chairman	\$1,050,000	\$1,300,000	\$3,101,400	\$2,068,000	\$7,519,400
Timothy O. Mahoney	Aero President & CEO	\$907,462	\$900,000	\$3,015,250	\$1,862,500	\$6,685,212
Andreas C. Kramvis	Vice-Chairman	\$850,000	\$1,050,000	\$2,842,950	\$1,488,000	\$6,230,950

(A) No growth plan award was made in 2015; last grant was made in 2014. 50% of the earned award for the completed 2014-2015 (2-year) performance cycle is attributed to 2015 and shown on the table above to reflect the fact that Growth Plan performance cycles do not overlap, consistent with how the Committee plans executive compensation.

(B) Reflects the Committee's view of how annual compensation should be determined, which differs from the methodology required by the SEC for purposes of the [Summary Compensation Table](#).

### *Base Salary*

Base salaries for executive officers are reviewed annually by the compensation committee early in the fiscal year, with any changes becoming effective in Q1. It is based off of the scope of responsibility as well as the years of experience held by each NEO, with reference to market compensation data for HON's peers.

### *Annual Cash Incentive Awards<sup>3</sup>*

Annual cash incentive awards reference a baseline amount, which is adjusted for performance versus pre-established performance goals, supplemental criteria, and individual performance. Baseline amounts are determined by a review of year over year change in actual award value in the context of performance for the prior year as well as actual award relative to the initial baseline level. Maximum award is capped at 200% of the notional target (CEO 350% cap).

For 2015, the 3 pre-determined metrics were adjusted EPS (excluding pension mark to market adjustments), operating free cash flow (excluding capital expenditures), and working capital turnover (sales divided by the quantity trade accounts receivable plus inventory less accounts payable and customer advances).

The following table displays the target goals. These goals reflected an 8.8% year-over-year (YoY) growth rate in adjusted EPS and a 8.14% growth rate in adjusted operating free cash flow.

**Figure 6: Incentive Cash Plan Performance Metrics and Commentary<sup>4</sup>**

Metric	2014 Actual	2015 ICP Goal	Basis for 2015 Goal	2015 Actual Performance	2015 Performance Comments
EPS <sup>(1)</sup>	\$5.56	\$6.05	The 2015 Target represented the midpoint of the initial guidance range provided to investors in December 2014.	\$6.10	Actual 2015 performance exceeded the ICP goal. Represented a 10% increase over 2014 Actual EPS and a new record-level of performance for the Company.
Free Cash Flow <sup>(2)</sup>	\$3.93 billion	\$4.25 billion	The 2015 Target represented the midpoint of the initial guidance range provided to investors in December 2014.	\$4.38 billion	Actual 2015 performance exceeded the ICP goal. Represented an 11% increase over 2014 Actual FCF, reflecting continued strong quality of earnings and effective cash management.
Working Capital Turns ("WCT") <sup>(3)</sup>	7.0 turns	7.2 turns	Target was set to challenge business unit executives to improve the efficiency of operations to an extent believed necessary to achieve our Free Cash Flow goal.	6.6 turns	2015 performance was lower than the ICP goal. Represented -.4 turns change versus 2014, as the continued slow macro environment impacted the inventory component of WCT in ways that were outside the Company's control. The Committee decided to underweight this goal after considering Honeywell's outstanding free cash flow performance, which is closely linked to WCT. The Committee also considered data demonstrating that Honeywell is already performing at high levels relative peers on WCT. To emphasize FCF and EPS as the primary focus for ICP at the total Honeywell level, the Committee has removed WCT as a Pre-Established ICP Goal beginning in 2016, but will continue to drive improved WCT performance at the SBG level.

These targets reflected the continued difficult business environment in 2015 from a weak macro environment resulting from slower global growth, low oil prices, and a strong U.S. dollar. As such, supplemental criteria taken into account included core organic sales growth; segment and overall profit margin improvement; high growth region penetration; operational outperformance against compensation peer group on metrics like adjusted EPS, sales, net income, and return on invested capital (ROIC); and the impact of weak macro factors. Individual performance was based on a list of individual accomplishments relating to new business wins, strategic cost cutting initiatives, etc. in a list available on pp.43-45 of the proxy report. The final cash bonus awards approved by the Committee are shown below in figure 7.

<sup>3</sup> 2015 HON Proxy Statement pp. 37-40

<sup>4</sup> Honeywell 2016 Proxy Report p. 42

**Figure 7: Actual Incentive Cash Plan Payout<sup>5</sup>**

	Baseline ICP Amount	Business Financial Results "V" <sup>(1)</sup>	Preliminary 2015 ICP Award	Adjustment Based on Individual Assessment <sup>(2)</sup>	Actual 2015 ICP Award (rounded)
Mr. Cote	\$5,500,000	+4%	\$5,720,000	0%	\$5,700,000
Mr. Szlosek	\$ 700,000	+4%	\$ 728,000	17%	\$ 850,000
Mr. Fradin	\$1,200,000	+4%	\$1,248,000	4%	\$1,300,000
Mr. Mahoney	\$ 800,000	+4%	\$ 832,000	8%	\$ 900,000
Mr. Kramvis	\$ 950,000	+4%	\$ 988,000	6%	\$1,050,000

(1) Based on assessment of business unit performance against Pre-Established ICP Goals and Supplemental Criteria.

(2) Based on assessment of individual performance and impact.

### Long Term Stock Options

Long-term stock options create a financial incentive to achieve improvements in performance over the 4 year vesting period, with 25% vesting each year. The size of each stock option grant for the CEO is dependent on relative shareholder returns and operational performance as well as grants made by compensation peers. For other NEOs, individual performance and the potential to contribute to the future performance is used to determine award size. The sizes of the grants are listed below in figure 8.

**Figure 8: Stock Options Outstanding**

	# Options	Grant Date Value*
Mr. Szlosek .....	125,000	\$2,153,750
Mr. Fradin .....	180,000	\$3,101,400
Mr. Mahoney .....	175,000	\$3,015,250
Mr. Kramvis .....	165,000	\$2,842,950

\* Stock Options vest over four years. Value determined based on a Black-Scholes value of \$17.23 per option.

### Growth Plan

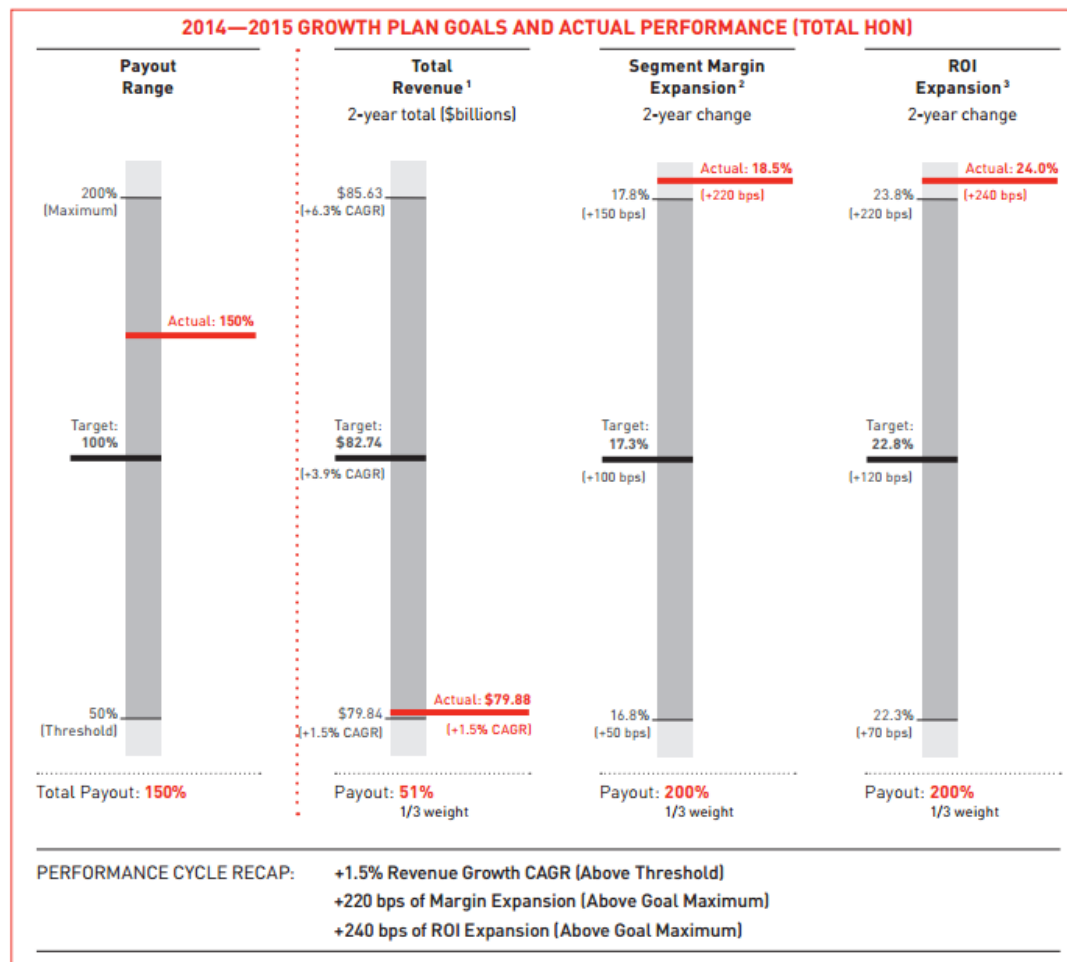
The growth plan is a performance-contingent, cash-based longer term incentive award plan which focuses executives on the achievement of two year financial metrics aligned with long term growth targets. Growth plan units are awarded at the beginning of the two year period with a \$100 target value each with performance metrics weighed equally in determining final payout and a max value of 200% of target. Payment is distributed over the third and fourth years after inception of the plan equally. Long-term metrics include revenue CAGR of 3.9%, segment margin improvement of 100 bps, and return on investment (ROI) expansion of 120 bps. Actual payout is shown below in figure 9.<sup>6</sup>

<sup>5</sup> Honeywell 2016 Proxy report p.44

<sup>6</sup> Ibid pp.47-52



**Figure 9: Growth Plan Goals and Actual Performance**



All in all, the well-balanced management compensation plan can be seen as one of the main drivers behind the company's consistent history of management execution and margin expansion. Acquisition strategy has been disciplined, with most deals before the recently failed UTX merger under \$2 billion as simple bolt-on acquisitions with relatively easy integrations. Besides M&A, free cash flow deployment in the form of share repurchases remain strong, with \$2.2 billion still remaining from the \$5 billion board authorization in December of 2013.<sup>7</sup>

### Dividend and Shares Outstanding History

The Company has gradually increased its dividend payouts in recent years, from \$0.20 annually per share in 2010 to a projected \$0.595 per share in 2015. The current figure represents a dividend yield of 2.1%, which is slightly above the S&P 500's average dividend yield of 1.9%. Besides dividends, management has allocated a significant amount of capital towards repurchasing shares. In recent years the company's shares outstanding has gradually decreased from 1,131 million shares in 2010 to 967 million shares through Q4 2015. During the recent trough in equity markets, management purchased roughly \$1.16 billion of stock at lower attractive prices (HON traded between \$96 and \$106 per share). This

<sup>7</sup> 2015 Honeywell 10-K p.12



commitment to returning cash to shareholders was reaffirmed in April of 2016, when the board authorized a new buyback plan of \$5 billion.

## Management Guidance

During the 1Q 2016 earnings call, management reported Sales of \$9.5 billion, well above the high end of prior guidance. CEO David Cote cited significantly greater than expected growth in Aerospace, Commercial Aftermarket, Transportation Systems, Process Solutions, as well as the residential, commercial, and Chinese ACS businesses. Excluding the dilution from the integration of lower margin product lines from the Elster acquisition, margins actually expanded by 20 basis points on an organic level. For the fiscal year 2016 and 2017, management has guided top-line growth of 5.5% and 5.2%, respectively, with an operating margin expansion of between 10-50 basis points in 2016 up to the 18.9-19.3% range. In the long run, management established an operating margin (not adjusted for depreciation) goal of 22-23% which they hope to achieve through expanding sales of new higher margin products across the board, integrating its various business under the enterprise solutions platform HOS gold, and strategic M&A.

Figure 10: Management Guidance Table<sup>8</sup>

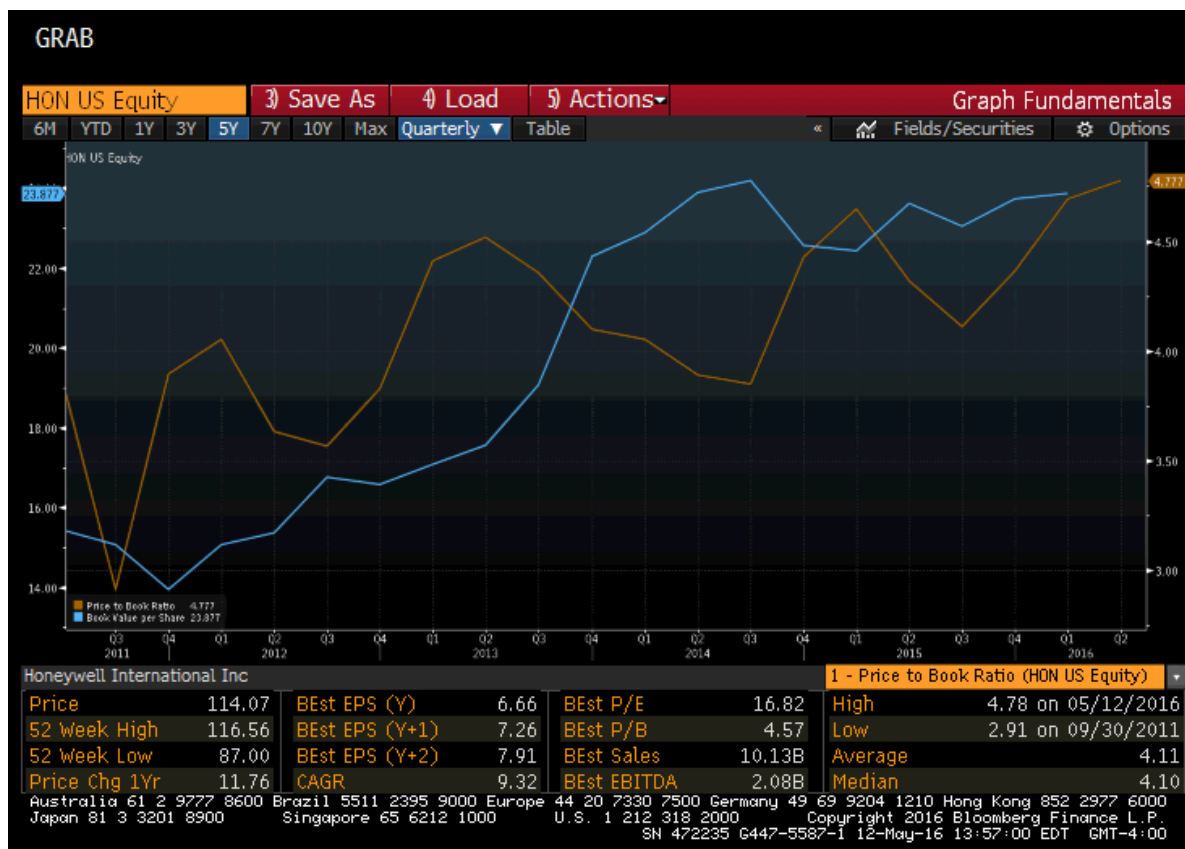
GRAB						
HON US Equity		95 Output to Excel	96 Alert	97 Settings	Company Guidance	
Honeywell International Inc		Periodicity		Annually	Currency	
					USD	
					Estimate Actual	
		FY 2012	FY 2013	FY 2014	FY 2015	FY 2016 Est
		12/31/2012	12/31/2013	12/31/2014	12/31/2015	12/31/2016
1) EPS Adjusted Guidance		4.47	~4.93	~5.53	6.10	~6.63
2) - Estimate		4.48	4.95	5.54	6.10	6.66
3) - Actual		4.48	4.97	5.56	6.10	7.26
4) Revenue Guidance		37.50B	~38.90B	~40.15B	38.50B	~40.60B
5) - Estimate		37.60B	38.87B	40.23B	38.57B	40.61B
6) - Actual		37.67B	39.06B	40.31B	38.58B	42.16B
7) Cap Expend Guidance		-900.00M	-1.20B		-1.30B	-1.10B
8) - Estimate		-911.38M	-940.63M	-1.12B	-1.18B	-1.10B
9) - Actual		-884.00M	-947.00M	-1.09B	-1.07B	-1.01B
10) Free Cash Guidance		3.70B	3.70B	3.90B	~4.25B	~4.70B
11) - Estimate		2.97B	3.68B	3.99B	4.21B	4.74B
12) - Actual		2.63B	3.39B	3.93B	4.38B	5.42B
13) Tax Rate Guidance		26.50%	26.50%	26.50%	26.50%	
14) Cashflow from Ops Guid		3.60B				
15) Net Income Adjusted G				~4.35B	~4.85B	
16) - Estimate		3.54B	3.94B	4.41B	4.83B	5.16B
17) - Actual		3.55B	4.39B	4.81B	4.81B	5.61B
18) Operating Income Guid		5.15B	~5.70B	~6.10B		
19) - Estimate		5.47B	6.34B	6.51B	7.09B	7.57B
20) - Actual		4.16B	5.50B	5.83B	6.83B	8.11B
*Period Notes						
Australia 61 2 9777 8600 Brazil 5511 2395 9000 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000						
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2016 Bloomberg Finance L.P.						
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<sup>8</sup> Bloomberg Terminal (Function: <GUID>)

## Multiples

Over the last five years, Honeywell has had an average Price to Book value Ratio of 4.11 (Figure 11). Its current book value per share is 23.88. By combining these two metrics, this implies that Honeywell has a valuation of \$98.15 per share on a book value basis. Using the current price to book value of 4.77, a valuation of \$113.91 is derived. While both of these imply that Honeywell may be overvalued on a book value basis, management's dedication to share buybacks (which should increase book value per share) while sticking to smaller M&A deals should mitigate this concern.

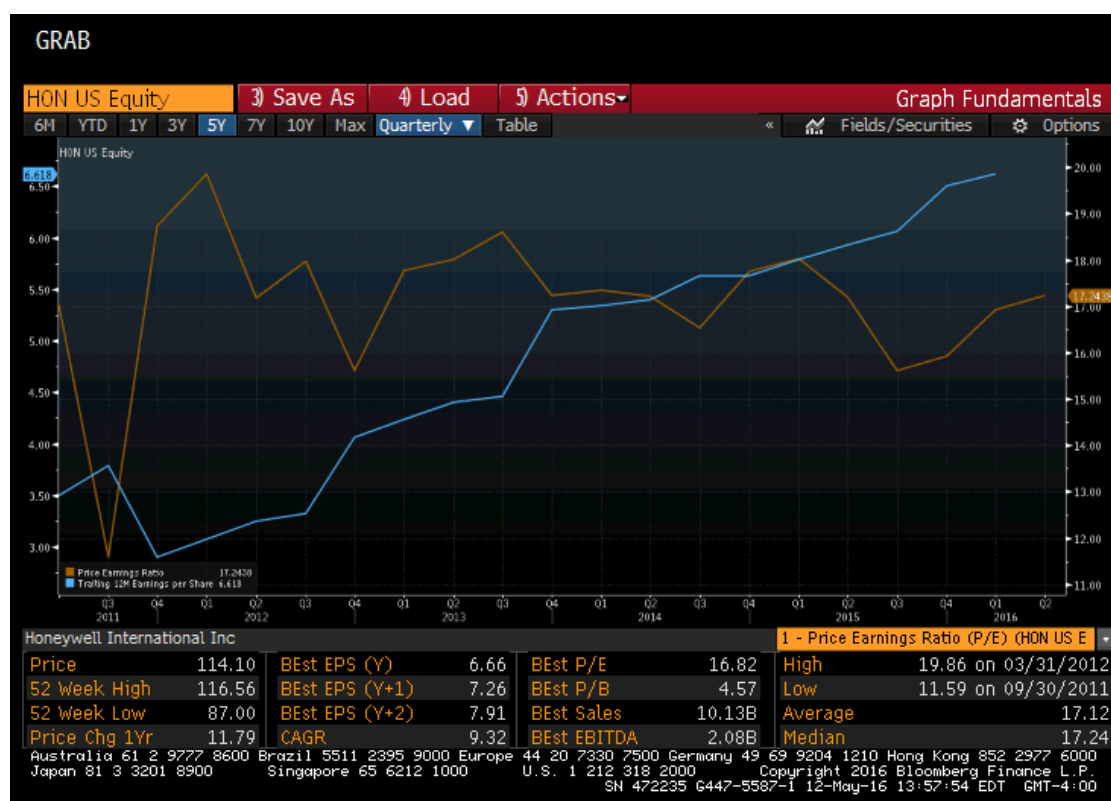
**Figure 11: Honeywell Price to Book Ratio versus Book Value per Share (5 years)<sup>9</sup>**



Using a 5 year average P/E ratio of 17.12 and the current trailing twelve months earnings per share (EPS) figure of \$6.62, a valuation of \$113.33 is derived. The current P/E of 18.71 implies a valuation of \$123.86. While the average price to earnings ratio-based valuation may also indicate that Honeywell is overvalued, this concern is mitigated by management's capital allocation strategy. With \$5 billion more of authorized buybacks on the table, EPS growth should continue as management continues to expand margins even during periods of slower than expected top line growth. Additionally, based on Honeywell's high quality management which has a long track record of execution as well as the firm's outperformance versus its peers, investors will continue to attach a premium to Honeywell shares that should support our optimistic forecast as margin expansion continues in the firm's mostly healthy end markets.

<sup>9</sup> Bloomberg Terminal (Function: <GF>)

Figure 12: Honeywell Earnings per Share vs. Price to Earnings Ratio (5 years)<sup>10</sup>



## Share Ownership and Insider Trading

In the list of Honeywell's largest shareholders (figure 13), the top 10 is split evenly between providers of exchange traded funds like Vanguard and State Street as well as traditional mutual fund providers like Wellington Management and JPMorgan Funds. Of note is the large holdings of mutual fund sub-advisor Barrow Hanley Mewhinney & Strauss, which assists in the implementation of large cap mutual funds such as the Touchstone Value Institutional (TVLIX, 4 stars on Morningstar) and Transamerica Dividend Focused I (TDFIX, 4 stars on Morningstar).

During the volatility that has affected both overall industrial equities as well as Honeywell shares in the half year, management has taken advantage of negative price swings to purchase additional shares of company stock at undervalued. This not only reflects strong conviction about the company's upside as an investment opportunity, but also further aligns the incentives of management with Honeywell's shareholders.

<sup>10</sup> Bloomberg Terminal (Function: GF)

Figure 14: Top Honeywell Shareholders<sup>11</sup>

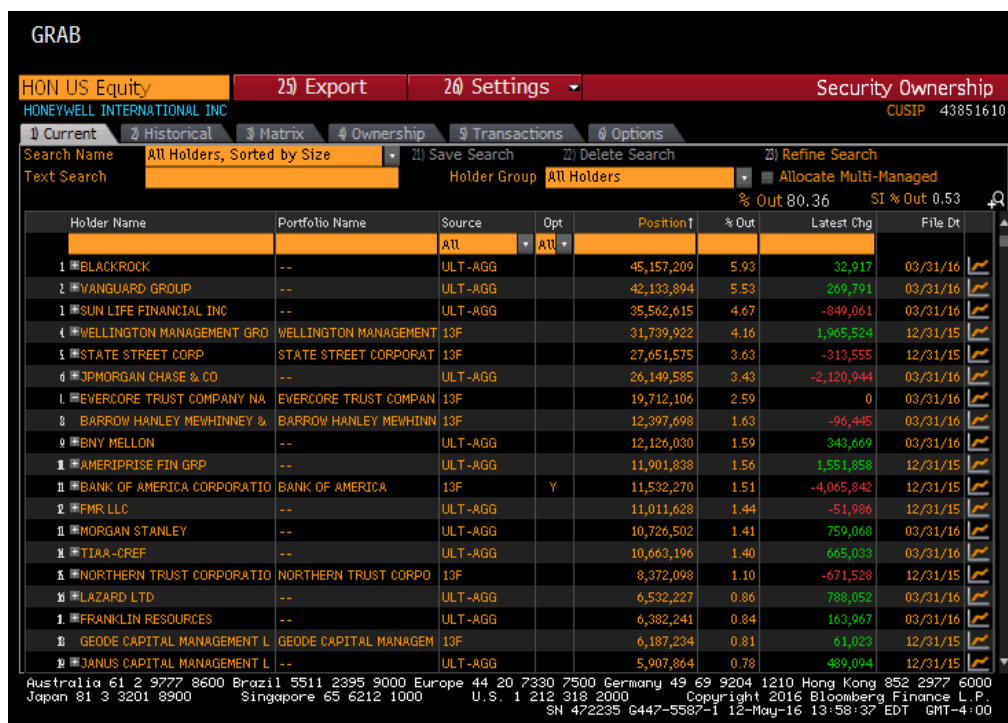
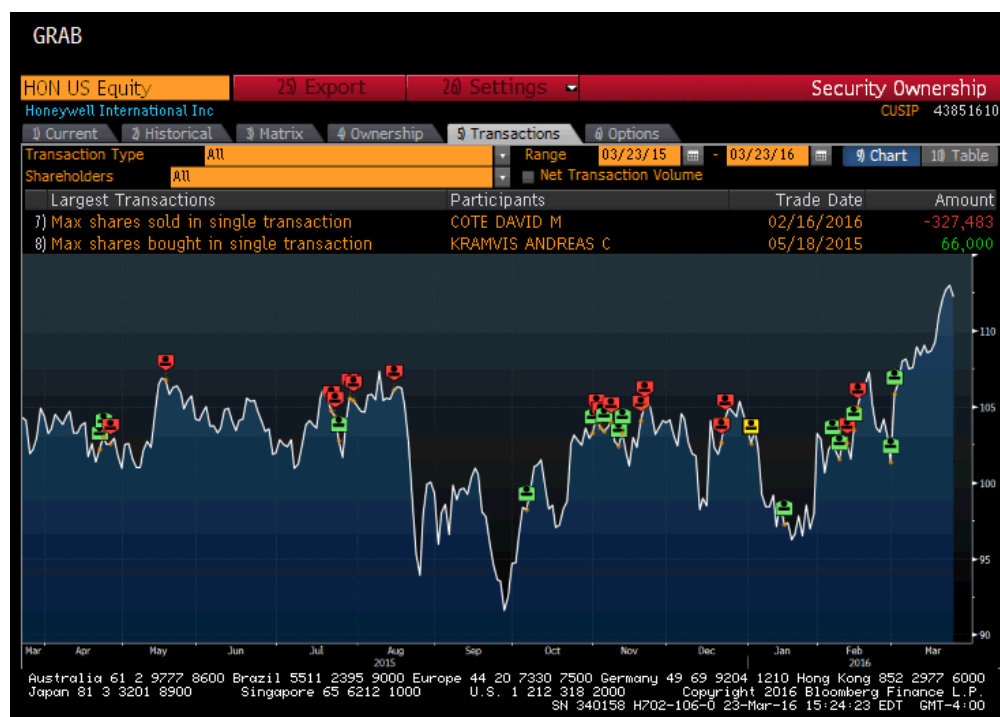


Figure 15: Honeywell Insider Trading (1 year)<sup>12</sup>



<sup>11</sup> Bloomberg Terminal (Function: OWN)

<sup>12</sup> Bloomberg Terminal (Function: GPTR)

## Conclusions:

Based on the HG-DCF-MC and management compensation it is clear that the current stock price of \$114.11 leaves some room for upside with a Monte Carlo percentile of 23%. A strong record of execution by management on integrating acquisitions and margin expansion gives should also help offset industry headwinds and uncertainty in the future. While Honeywell's recent gains has reduced its total investment upside, I will still rate it a **buy** due to its strong aerospace franchise, opportunities from the integration of Elster into ACS, and good positioning around the petrochemical and natural gas sectors. Though significant risks exist in the condition of global construction markets as well as the peak of the refining cycle, HON is well positioned to outperform many of its industrial peers due to their exposure to better end markets and strong management track record of margin expansion.