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REAL-TIME REPORTING FROM BLUE HERON RESEARCH PARTNERS

## Not Ready for Takeoff

TROUBLES WITH BOEING'S DREAMLINER MAY RIPPLE THROUGH TO SUPPLIERS

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### ABOUT BLUE HERON RESEARCH PARTNERS

Blue Heron Research Partners is an independent firm that provides fundamental analysis to institutional investors on an exclusive, real-time basis. Our focus is on issues that drive performance, ranging from the strategic and execution skills of a management team to trends taking shape at the sales and operational levels. Our methodology combines investigative journalism and classic value investing tools.

The much-delayed debut flight of Boeing's 787 "Dreamliner" is now scheduled for three days before Christmas. But even if the test plane gets aloft, any glad tidings for Boeing's suppliers will remain a long way off.

That's the perspective we picked up from talks with a number of engineers and other aircraft personnel who have worked on the 787 project. The Dreamliner has been plagued by some of the very innovations Boeing heralded in its development. Rather than handling the bulk of manufacturing in-house, Boeing is acting as more of a systems integrator on the 787, with scores of suppliers on contract around the world. And instead of assembly taking place under one roof at its Seattle base,

Boeing has opened a second production plant in Charleston, S.C.

This shift to outsourcing was meant to be a breakthrough in selecting best-in-class components and reducing overhead and financial risk for Boeing. So far, however, Boeing has suffered headaches from repeated delays in the 787 takeoff, which is now more than two years behind schedule. Meanwhile, its suppliers have been whipsawed by a number of design and fabrication issues, especially with the tricky engineering involved in the 787's extensive use of advanced composite materials in place of aluminum.

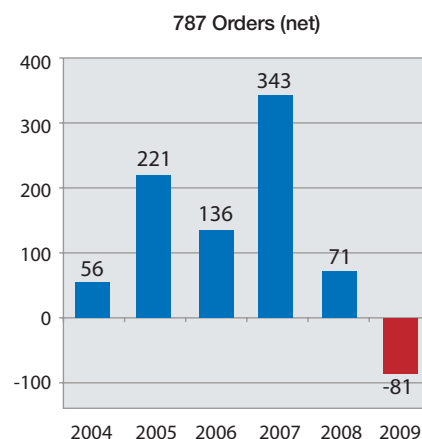
**CREEPING ALONG:** The suppliers include several midcap aerospace companies that already are under stress from the global slump in airline travel and a huge falloff in aftermarket demand. **These include names like Goodrich (GR), Spirit Aerosystems (SPR), Rockwell Collins (COL), and Triumph Group (TGI)**, where the 787 order book is expected to be a significant revenue item. (Other suppliers that are units of large conglomerates like United Technologies, Honeywell, and GE can obviously absorb a delay more easily.)

The pressure on the suppliers, our sources said, has been twofold. First, they ramped up for design and production based on Boeing's original schedule—the initial plane orders were placed in 2004, while full production is now seen in late

*Continued on page 2*

### Stalled Out

Boeing's order book for the 787 dropped by 10% in 2009, as cancellations swamped new orders.



Source: Boeing

**BOEING** (continued from page 1)

2010, at best. When the timetable slipped, the suppliers had to start cutting costs through layoffs. Second, the ongoing changes to the 787 specs have often ended up in the supplier's lap. The so-called "creep" in component costs is now a very sore spot between Boeing and some of its major suppliers, with hundreds of millions of dollars in contract adjustments in dispute.

What's more, the second plant in South Carolina has added another level of frustration for Boeing suppliers. According to a former aerospace business development manager, the dual plants mean that Boeing's outsourcing approach to the 787 can lead to more hiccups in communication and supply chain controls. "Airplanes have changes all the time, so each plane can be different in some form," he said. "So when you have two plants, you have an engi-

neering continuity problem."

And Boeing is not noted in the industry for rapid response to its vendors. An executive at a composites company told us that when he has a technical question about a part, "it will take months to get an answer from Boeing," because of all the management layers to go through. He contrasted that with Lockheed, which he said is more nimble because of its orientation to military projects and a strong engineering culture. That may be part of the reason Boeing changed management of the Dreamliner this year, with several executives moved over from its defense unit.

**FIRM ORDERS?** Even when the 787 finally gets off the runway, the suppliers will see less of a benefit than they're used to from the other aircraft. That's because the design enhancements in the Dreamliner—lighter components,

greater fuel efficiency, fewer welds—will pay off for the airlines with reduced maintenance. The 787s should be able to stay in the air more, but that is likely to mean lower demand for aftermarket service and spare parts.

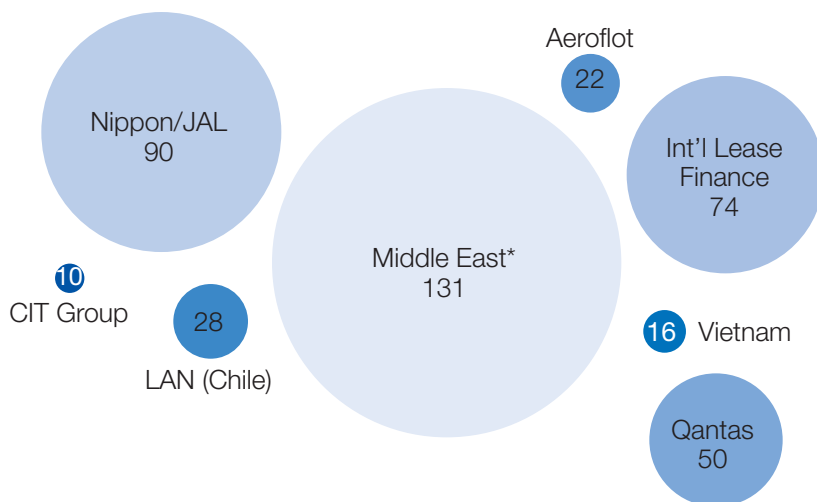
Finally, there are reputational issues that may dog the 787. Although several of our sources said the delays on the Dreamliner were not unexpected, given the plane's technological and manufacturing challenges, Boeing's performance record has clearly suffered. "The delays are significant," said a project manager at a 787 subcontractor. "They've created a lot of damage to Boeing's image." Another source predicted that FAA certification of the plane will take longer than Boeing expects, with approval and delivery unlikely before 2011.

As a result, Boeing is losing ground to archrival Airbus with some customers. The momentum Boeing had in 787 orders ground to a halt in 2009, with cancellations far outweighing new orders. **We'd also have some concerns about the current order book as well (see chart).** Nearly 20% of orders are from Middle Eastern airlines, where the once-booming oil economies are showing signs of stress. Another large customer is International Lease Finance, which is in the process of being sold by AIG and may have to revisit its capital budget. And bankrupt CIT Group still appears on the order list, with 10 planes to its name.

We think there is a lot of turbulence ahead for companies connected to the 787—and of course Boeing itself, which is at an inflection point with this massive project. Investors who want to get a deeper picture should give us a call. ■

**Over There**

The biggest customers for the 787 are mainly state-controlled or subsidized airlines and lease companies. Many of these are not in the rosiest health these days, which could lead to more cancellations or postponements.



\* includes UAE, Qatar, Bahrain, Kuwait, Dubai airlines

Source: Boeing

## IN THE NEWS: VIDEO GAMES CONSOLES

## Price Cuts Boost Sales, But At What Cost?

## GAME ON

The video game business looks increasingly like Hollywood. The top software publishers rely on blockbusters to drive their business, with titles taking years and tens of millions of dollars to develop and market. New hits are rare; the three hottest game releases this fall were all follow-ups: Microsoft's Halo 3, Sony's Uncharted 2, and Activision's Call of Duty: Modern Warfare 2.

Our survey of 30 retail outlets confirmed this trend. The store clerks named these titles as the most desired game:

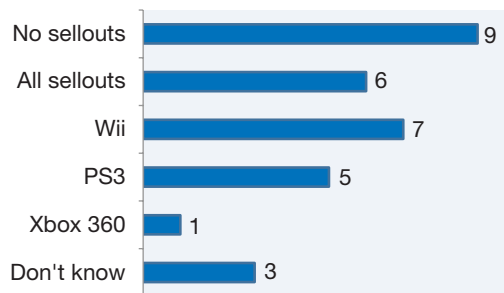
**Call of Duty: Modern Warfare 2** (12 stores)  
**Publisher:** Activision  
**Consoles:** PS3, Xbox, PC

**Halo 3 ODST** (8 stores)  
**Publisher:** Microsoft  
**Console:** Xbox

**Uncharted 2** (5 stores)  
**Publisher:** Sony  
**Console:** PS3

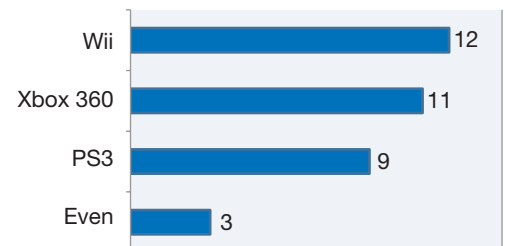
**Madden NFL 10** (5 stores)  
**Publisher:** EA Sports  
**Console:** PS3, Xbox, Wii, PC

Which Console is Most Likely to Sell Out Over the Holidays?



Source: Calls to 30 retailers (GameStop, BestBuy, WalMart, Target) in Boston, Atlanta, Chicago, Houston, Los Angeles; Nov. 2009.  
 Note: numbers add to more than 30 due to multiple answers.

Which Console is the Hottest Seller Right Now?



**THE BUZZ:** A series of hefty price cuts has revived the fortunes of video game console makers.

**REALITY CHECK:** There's no doubt that slashing the price of a gaming system by \$100 can move a lot more units. Just before Labor Day, both Sony and Microsoft announced they were marking down the retail price for their consoles, the Playstation 3 and Xbox 360, by a hundred bucks, to \$299. Nintendo, which has long led the category with its fun-for-all-ages Wii system, finally followed suit in late September, taking a more modest \$50 cut, to \$200.

The immediate result: **the PS3 topped its rivals for the first time**, selling 491,800 units in September, according to data compiled by NPD Group. In October, following its own price cut, the Wii returned to its customary top spot, with 507,000 units sold. And even though the Xbox finished third both months, NPD reported its sales were running 30% ahead of the pre-discount figures.

**So far, so good—for the game addicts.** They presumably would take the \$100 savings and buy a couple more games. That helps out the game publishers, who have been suffering from the recession and a dearth of hit new titles. Indeed, the arrival of some long-awaited new games has boosted their fortunes (see "Game On," left).

But all these signs of health need to be put in context. Even with the console price cuts, videogame hardware sales in October were down 23% from a year ago, with software sales down 18%. A continuing weak economy, plus saturation of the teen-to-30something audience, is stalling out the console sales. **You can only imagine how bad the results would be without the discounts.**

So how to approach this sector? We did a quick field check in early November to gauge which console would have the most traction over the holidays. Here, the news was good for perennial laggard Microsoft. Its Xbox 360 nearly tied the Wii for "hottest console," with several store clerks mentioning its online gaming and streaming HD movie capabilities as key advantages. On the other hand, only one of the 30 stores we called expected the Xbox 360 to be the sole console to sell out—perhaps an indication that Microsoft is stuffing the channel. (Nine of the stories predicted that no console would sell out, while six said all three would be gone.)

**The bottom line: once the holiday passes, and the special bundle offers go away, the lower price points for the consoles are likely to lose their appeal.** Unless the economy suddenly perks up, we'd say it's Game Over for better console results through most of 2010. ■

## RESEARCH BRIEFS: FOLLOW-UPS

## A Buffett Bet on Management; Holes in Fancy Jeans

OUR WORK ON BURLINGTON NORTHERN'S CEO AND TRUE RELIGION'S PROSPECTS HIT THE MARK

## TRANSPORTATION

## The Right Track

When Warren Buffett announced he was spending \$26 billion to take full ownership of **Burlington Northern Sante Fe (BNI)**, most analysts interpreted the move as a large bet on the American economy's revival. But Buffett, in typical fashion, was selective about placing his chips. He has held stakes in other large railroad operators, such as Union Pacific and Norfolk Southern.

So what tipped the scales to BNI? We'd suggest it was Buffett's desire to find the best managers in an industry, give them the capital they need, and then sit back and let them run their business. In this case, Burlington CEO Matthew Rose was the standout candidate.

Rose was the subject of a Blue Heron due diligence report in August 2007. ***We interviewed 10 senior executives in the railroad and trucking industries, and came away with a glowing review of Rose and his management skills.*** Rose was a dark horse at Burlington. At one point, as a source told us, he thought his career at the company was over, when former CEO Rob Krebs, who came from Santa Fe, was taking over and relying on his team.

But Rose, despite his youth, shone on several assignments for Krens. When he became CEO in December 2001, at 41, he brought a fresh vision to the busi-

ness. "He looks at things from a new perspective," said another source. "He had foresight regarding intermodal... and he has the skills to juggle operations without over-managing."

According to our interviews, Rose saw that the railroads, with the proper investments and cost controls, could compete effectively with truckers for long-haul business, especially as fuel costs started to rise. He clearly moved faster than his rivals in developing a customer-focused model. And ultimately, his age became a positive for Buffett, who likes to have his managers in place for a long time.

Rose was described to us as "a very well balanced young man" who is "smart," "personable," "energetic" and "tough." He has an "enormous amount of drive" and "an innate sense of leadership." For our client, these kinds of character notes paid off handsomely—and would eventually match what Buffett found.

## RETAIL

## Losing Faith

In our September issue, we made calls to 15 retail store sources about **True Religion (TRLG)**, the trendy, high-priced jeans maker. With average selling prices of \$250 for women's jeans, we asked our sources whether the brand had enough pull to keep attracting buy-

ers in a down economy. Most said the pricing was holding up, but some questioned whether the name was still considered cutting edge. We also noted that TRLG was opening its own stores at a rapid rate, an aggressive move beyond its affluent, upscale market roots.

The company's Q3 results, announced on Nov. 3, signaled that it was perhaps getting too big for its britches. Although earnings were light by just a penny, the stock got crushed, falling from \$26.50 to \$20 the next day. It has since traded down to around \$18, a steep 30% decline overall.

The company said it would continue the new-store binge, in part to make up for slack sales at the wholesale level to department stores and boutiques. It also said it would introduce "less embellished" jeans at lower price points.

In other words, ***the hotness factor may be cooling off. Yet we would now take a closer look at the stock for some upside.*** TRLG is cheap, trading at 10 times next year's earnings and with nearly \$4 per share in cash and no debt on the books. The jeans may have frayed a bit, but they're now priced more reasonably—just like its shares. And because our sources reported continued enthusiasm for the brand, it may only need this more wallet-friendly approach to keep it within reach of the fashion crowd. ■

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## VIEWPOINT

## Of Singing Elves and Tone-Deaf Management

KNOWING HOW TO TALK TO EMPLOYEES CAN LEAD TO KEY INSIGHTS



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Our theory was that we could transfer the same interviewing skills we use to evaluate senior management to find out whether a company's workforce was executing its strategic plans.

As I type this, my right ear is glued to the phone and one thought perplexes me: "How much longer will I have to be on hold with customer service at Best Buy?" We're in the final weeks of 2009, and I've been trying to buy a new TV to surprise my kids for Christmas. But Best Buy messed up my order.

An email sent a day earlier informed me that the store where I wanted to pick up the TV no longer exists. So for the last two nights, I've spent a total of four hours bouncing around call centers in Colorado and Missouri. I've been disconnected seven times in the middle of calls. To top it off, the one person I managed to reach told me that the TV I already paid for will now cost me an additional \$300. And the clock is still ticking.

Aside from the annoyance of listening to shrill elves shout holiday songs re-worded as sales promotions, this moment reminds me of a project we did two years ago on Circuit City. At the time, a lot of investors were swooning over efforts by management to increase margins. The plan spearheaded by CEO Phil Schoonover included firing thousands of experienced store employees and replacing them with cheaper labor. He also eliminated department specialization. He fired all the techno-geeks that most of us need to convince us to spend \$1,000 on a gadget.

The result was disastrous. Since customers could no longer get detailed advice on items like TVs and cameras from trained sales people, they went across the street to Best Buy, where service was seen as superior. Any employees who aspired to do better soon understood the fate that awaited them once their pay hit about \$16 per hour. Morale collapsed, sales declined, and metrics like shrinkage—the amount of merchandise stolen by employees—soared. Then came bankruptcy and liquidation.

Blue Heron was ahead of the trend on Circuit City. After interviewing several dozen

store-level employees and scores more who had recently left the ranks, we were able to piece together the sad picture. We were shocked by the troubles we unearthed.

This was in the early stages of our effort to take channel checking to a new level. Our theory was that we could transfer the same interviewing skills we use to evaluate senior management to find out whether a company's workforce was executing its strategic plans. In other words, did the body understand what the head was telling it?

We knew that other firms had been doing channel checks for years, but their focus tended to be on data points, rather than deeper insights into the prospects for a business. Numbers are important, no doubt. But we felt that if we took the time to talk to sources and listen to their views from the store or shop floor, we could get a much better grasp on conditions.

Circuit City was an important test of our technique and also of our resolve. Our client on the project doubted us. When the analysts took a summary of our reporting to the company, management said we didn't know what we were talking about. Our client—well, former client—agreed with management. In the end, we were proven right. That experience of being out of step with the consensus emboldened us, because we understood that we'd done the interviewing and digging needed to get the real intelligence.

So am I saying that Best Buy is the new Circuit City? It occurred to me, entering a fifth hour of customer service hell, that I wouldn't have been left on hold this long if Best Buy's direct competitor hadn't committed suicide. And perhaps if management at Circuit City had listened to its own employees—or if our client had believed us and told management to pay attention—I might be watching my new TV instead of being tortured by singing elves. ■