United Technologies Corporation, July 2010[1]

On July 21, 2010, United Technologies Corporation ('UTC;' Ticker symbol: *UTX*) announced its second quarter results for fiscal year (FY) 2010. Revenue was up 5% compared to the year prior, and profit up 14%, resulting from higher demand for the company's Sikorsky helicopters and Carrier heating, ventilation and air conditioning (HVAC) systems.

About 4% of the revenue increase came from organic growth, with the remaining 1% coming from acquisitions. Given that 60% of UTC's revenues come from outside the US, the company's reported US$ growth was also subject to the effects of currency swings. Even though the US$ had appreciated against most world currencies in the past six months, hedging strategies in place has neutralized impact on revenues.

CFO Greg Hayes expressed satisfaction with the 'solid results' across all divisions of the company, and noted that it was the 'first organic revenue growth rate since Q4 of 2008.' He pointed to the company's relentless focus on cost reduction through the recession of 2008-09, and to 'strong cash flow generation [resulting] from tight control over working capital and capital expenditure' as having been strong contributors to the turnaround, and to the increase in profit that far outpaced the revenue growth.

Even though Mr. Hayes expected UTC 'to face headwinds' from likely dollar appreciation in the second half of 2010, he raised UTC's earnings-per-share (EPS) forecast by 5¢, to $4.60 - $4.70 for FY 2010 (UTC's fiscal year ends on December 31). Analysts reacted positively to the news, with nearly every one reiterating (or improving) his or her recommendation of UTX to a 'buy,' 'outperform,' or 'overweight.'

On the trading day following the announcement, UTC's stock price went up 4%, to about $70 per share, giving it an equity market capitalization of approximately $64 billion.

In the prior year, the stock had risen by 23%, far outpacing the less than 7% increase in the value of the S&P 500 index during the same period. Louis Chênevert, CEO, noted with legitimate pride, that during the past decade, UTC was only one of two stocks in the Dow Jones Index (of 30 stocks) whose value had more than doubled.[2]

---

[1] This case was developed by Professor Anant K. Sundaram at the Tuck School of Business at Dartmouth solely as a basis for class discussion. Any errors of fact or interpretation are those of the casewriter. © August 2010.

[2] Mr. Chênevert, took over the role of CEO from George David in 2008. During his 14-year tenure as CEO, Mr. David presided over a nine-fold increase in UTC's share price, a period during which the value of the S&P 500 index of stocks increased just three-fold, and the share price of a key competitor, GE, five-fold. In order to replicate Mr. David's performance, Mr. Chênevert would need to take the stock from its current level to $630 per share by the 2024.

United Technologies

United Technologies is a multi-industry company that operates in six business segments, with globally recognized brand names in each: commercial and home HVAC systems (Carrier), elevators and escalators (Otis), jet engines for commercial and military aviation (Pratt & Whitney), commercial and military helicopters (Sikorsky), advanced aerospace and industrial products (Hamilton Sundstrand), and security and fire safety products & services (Kidde). In a broader sense, the company can be really thought of as operating in two broad markets: building infrastructure (Otis, Carrier, and Kidde), and aerospace/defense (Pratt & Whitney, Hamilton Sundstrand, and Sikorsky).

Originally incorporated as United Aircraft Corporation in 1934, the company formally changed its name to United Technologies Corporation in 1975. Many of the key brands and assets of the company were acquired over time: Otis in 1976, Carrier in 1979, Sundstrand Corporation in 1999, Chubb fire and security services in 2003, and Kidde in 2005, and GE Security in 2009.

A *Business Week* cover story on the company a few years earlier called UTC a classic decentralized industrial conglomerate with successful business units that "…derive little of their identity from UTC."[3] The article goes on to say: "What ties it all together is that each of UTC's businesses involve basic manufacturing – operations that are susceptible to quality improvements, efficiency improvements, and technological improvements. The ability to continually wring out incremental gains in those areas [which the CEO calls] 'process disciplines' is UTC's greatest strength."

Looking at the most recent full fiscal year results, UTC had 2009 sales of $52.9 billion (down 11.4% from 2008, thanks to the global recession), with 26.6% gross margin (i.e., sales minus cost of goods sold as percent sales), and 12.1% operating margin (i.e., earnings before interest and taxes as percent sales).[4] Net income for UTC in 2009 was $4.2 billion (i.e., 7.9% net margin), and the company paid 37% of its net income as dividends. About 60% of revenue came from operations in, and exports to outside the US. *Exhibit 1* shows UTC's key financials for fiscal years 2008, 2009, and the first half of 2010.

In the past five years, UTC's revenues had seen a compounded annual growth rate (CAGR) of 7.2%, while the CAGR in EPS during this time was 9.3%. Of the 7.2% in revenue growth, 4% came from organic growth, 2% from acquisitions, and the rest from favorable currency movements.

---

[3] "The Unsung CEO," *Business Week*, October 25, 2004.

[4] To put these numbers into perspective, the 5-year average gross margin and operating margin for the typical firm in the S&P 500 index of stocks were 26.7% and 16.8%, respectively. UTC's 2008 gross margin and operating margin were 27.0% and 12.8%, respectively.

The first half of 2010 (2010-1H) witnessed improvement across all business segments. The performance of each of the six business segments of UTC in 2010-1H, as well as the source of segment revenue growth, are shown in Panels A and B of *Exhibit 2*.

Current Business Challenges, Valuation Implications, and Assumptions

While analysts were generally bullish on UTC's prospects there were some concerns being expressed. The primary macro-risks that were cause for concern included worries about a possible − but likely remote − second slowdown in global economic growth, dollar appreciation (especially against the Euro), defense budget pressures, increase in raw material costs, and possible slowdowns in the US commercial aerospace and Chinese non-residential construction segments.

Company- and segment-level issues of concern most commonly mentioned by analysts were: The potential for contraction in Pratt & Whitney's installed base of large transport carriers, Fire & Security having a more challenging time meeting margin goals, Otis's exposure to exchange rates (especially against the Euro), increased R&D expenses in Hamilton Sundstrand, and the general continuing weakness in the market for commercial helicopters.

Overall revenue growth rates for all of 2010 (relative to 2009) are forecasted to be 3%, increasing by a further 5% in 2011, with growth rates then declining steadily over time to 3% per year by 2015.[5] Cost of goods sold (including depreciation charges) during the forecast period is expected to be 73% of sales, and SGA (including depreciation charges) 14.5% of sales, with UTC's Operating Income (or EBIT) therefore at 12.5% in 2010. Operating Income is expected to increase 0.5% per year, to 13.5% by 2019. Net working capital in 2010 will be 6% of sales, and this proportion is expected to decline slightly over the next decade. Capital Expenditure is 1.25% − 1.50% of sales during the forecast period, and UTC's Depreciation will equal Capital Expenditure.

Long-run growth rate in free cash flows would be determined by the long-run assumed return on invested capital (ROIC) and a "Re-investment Rate", which, in turn, is a function of operating profits and net capital investments − capital expenditure and change in operating net working capital – in the last forecast period.[6] ROIC in the long run could be assumed to be about 20%. (Capital markets data relevant to UTC, and for the US financial markets, are shown in *Exhibit 3*.)

[5] The revenue growth rate assumption is based on the organic, constant-currency, no-acquisition growth-rate.

[6] Specifically, Reinvestment Rate = [Capex − Depreciation + Change in Net Working Capital]÷[EBIT×(1−t)]. The long-run corporate tax rate can be assumed to be 34%.

Exhibit 1

United Technologies Corporation: Financials for 2008 – First Half of 2010
(US$ million, unless otherwise mentioned; Fiscal Year-end is December 31)

	2008	***2009***	***2010-1H***
Net Sales	59,757	52,920	25,981
Product Sales	*43,234*	*37,332*	*18,352*
Service Sales & Other	*15,588*	*16,523*	*7,629*
Cost of Goods Sold	43,637	38,861	18,747
R&D	1,771	1,558	856
SG&A	6,724	6,036	2,915
Depreciation & Amortization	*1,321*	*1,258*	*666*
Operating Income	7,625	6,465	3,463
Net Financial Expenses	689	705	378
Earnings before Taxes	6,936	5,760	3,085
Income Taxes	1,883	1,581	926
Other Income	−364	−350	−183
Net Income	4,689	3,829	1,976
Dividends	1,266	1,412	775
Assets			
Cash & Short Term Investments	4,327	4,449	4,997
Accounts Receivable	9,480	8,469	8,881
Inventories	8,340	7,509	8,083
Other Current Assets	2,320	2,767	955
TOTAL CURRENT ASSETS	24,467	23,194	24,401
Net Property Plant & Equipment	6,348	6,364	6,090
Goodwill	15,363	16,298	16,914
Net Intangible Assets	3,443	3,538	3,899
Other Assets	2,581	3,219	3,899
TOTAL ASSETS	56,837	55,762	58,343
Liabilities			
Accounts Payable	5,594	4,634	5,057
Short-term Borrowings	1,023	254	1,422
Current Maturities of LTD	1,116	1,233	604
Accrued Liabilities	12,069	11,792	11,679
TOTAL CURRENT LIABILITIES	19,802	17,913	18,762
Long Term Debt	9,337	8,257	10,039
Benefit and Pension Obligations	6,574	4,054	3,996
Other Long Term Liabilities	4,198	3,837	4,320
Equity	16,681	20,999	20,915
TOTAL LIABILITIES + EQUITY	56,837	55,762	58,343

Sources: SEC Filings, Annual Reports, Company website. Capital expenditure for 2008, 2009, and 2010-1H were $1,216 million, $826 million, and $302 million, respectively.

Exhibit 2

United Technologies: Segment Data for and Source of Segment Revenue Growth in 2010-1H

Panel A: Segment Data – 2010-1H

(US$ billion, unless otherwise mentioned)

	Sales	*Operating Income*	*Operating Margin (%)*
Otis	5.57	1.24	22.2%
Carrier	5.56	0.47	8.5%
Fire & Security	3.04	0.29	9.6%
Pratt & Whitney	6.19	0.96	15.5%
Hamilton Sundstrand	2.73	0.43	15.6%
Sikorsky	3.06	0.31	10.3%
TOTAL SEGMENTS	26.15	3.70	14.1%
General Corporate	–0.17	–0.24	--
CONSOLIDATED	25.98	3.46	13.3%

Source: Company 10Q filing.

Panel B: Source of Segment Revenue Growth – 2010-1H

	Total Growth	*Organic*	*Acquisition/ Divestiture*	*Currency-Related*	*Other*
Otis	–1%	–4%	1%	3%	–1%
Carrier	0%	5%	–7%	2%	--
Fire & Security	16%	–6%	17%	5%	--
Pratt & Whitney	–2%	–6%	0%	4%	--
Hamilton Sundstrand	–2%	–3%	0%	0%	1%
Sikorsky	12%	12%	0%	0%	--

Source: Company 10Q filing. 'NA' = not available.

Exhibit 3

United Technologies: Capital Markets and Other Data

(US$ million, except per share items; data for June 30, 2010 except noted otherwise)

Data Item	
No. of Shares Outstanding (Basic)	912 million
No. of Shares Outstanding (Fully Diluted)	927 million
Stock Price	$64.40
EPS for 2009	$ 4.17
EPS Guidance for 2010	$4.60 - $4.70
P/E Ratio (12/31/2009)	15.44*
Forward (12/31/2010) P/E Ratio	14.00 – 13.69
Market-to-Book Ratio	2.74
Price-to-Sales Ratio (12/31/2009)	1.11
UTC Credit Rating (S&P)	A
UTC Equity Beta	1.03
UTC Size Premium	0.29%
UTC Value Premium	0.06%
Estimate of US Market Risk Premium	6.00%
US Government 30-Year T-bond Yield	3.98%
'A' Spread Over 30-Year T-bond Yield	200 bp
Average Annual S&P500 Return (1900-2009)	10.86%
Average Annual S&P500 Return (1996-2009)	7.33%

Sources: *Company filings, company website, Bloomberg, Ibbotson Associates, finance.yahoo.com, finance.google.com*

** UTC's market capitalization as of January 1, 2010 was $64,400 million.*