

General Electric Company (GE)

Global Credit Research GCRE017

Credit Issues (4): Power Segment

- Disappointing results in FY18 due to slow market conditions, legacy obligations and execution issues: revenues down 22%, -\$808m of operating losses, -\$2.7bn of free cash flows; Operating profit to turn positive in 2019 but cash flows to stay negative until 2020
- In the short term, we believe GE has enough valuable assets to absorb negative cash flows from power. In the long term, focus on cash flow generation and a strict cost management are critical as the gas power market is negatively affected by cyclical and secular trends.

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Daiwa Securities Co. Ltd.

This is our fourth report in our GE series where we try to make clear the issues that GE faces at the moment. In our first three reports we looked into GE's debt problems: large borrowings with a concentration of debt maturities in 2020, large underfunded pension liability and a legacy position in insurance business that requires future contributions. For more details please refer to our previous reports:

[“General Electric Company- Credit Issue 1: Concentration of debt maturities in 2020” released on December 14th, 2018](#)

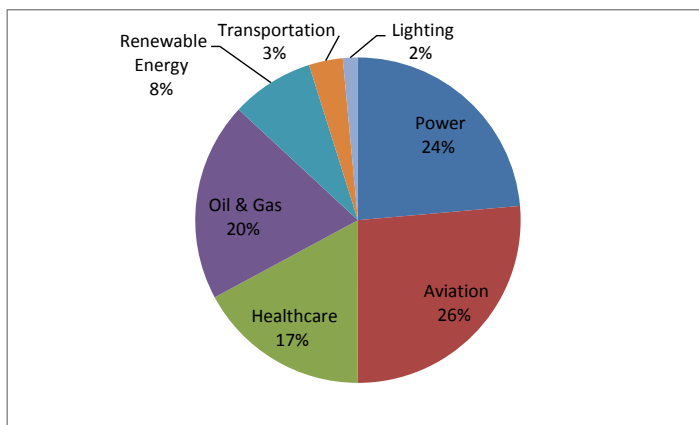
[“General Electric Company \(GE\)- Credit Issues \(2\): Pensions” released on January 17th, 2019](#)

[“General Electric Company \(GE\)- Credit Issues \(3\): Can GE eliminate its exposure to insurance operations?” released on January 28th, 2019](#)

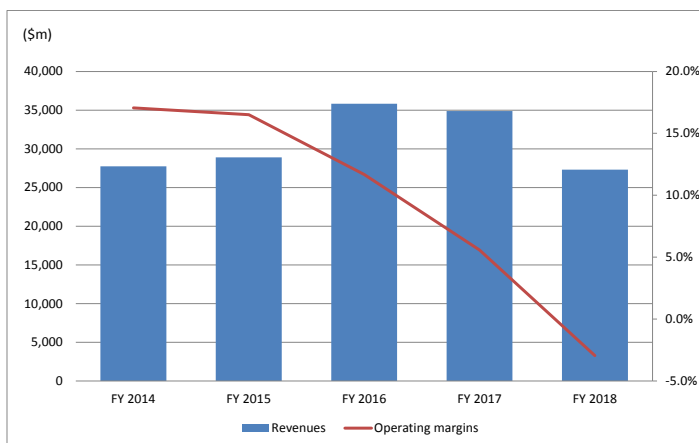
In this report we turn our attention to another big challenge for GE: the poor performance of the power segment which turned into red in 2018 and that is a severe drag on GE's cash flows. Power segment serves power generation, industrial, government and other customers worldwide with products and services related to energy production and water reuse. It employs approximately 59,700 people, serves customers in 150 countries and the headquarters is located in Schenectady, NY. In November, 2015, GE acquired power and grid segment from Alstom for \$10.1bn (purchase price net of cash acquired), the largest industrial acquisition in GE history. It proved to be a bad timing for expanding the power business as the power market slowed down afterwards. During the second half of 2018, GE recognized non-cash pre-tax goodwill impairment charges of \$22.1bn with the majority of the impaired goodwill being a result of the Alstom acquisition.

In 2018, GE completed two divestitures in the power business. In June 2018, GE completed the sale of Industrial Solutions business for approximately \$2.2bn (net of cash transferred) to ASEA Brown Boveri (ABB), a Swiss-based engineering company. In November 2018, GE completed the sale of Distributed Power business to Advent International, a global private equity investor, for approximately \$2.8bn (net of cash transferred).

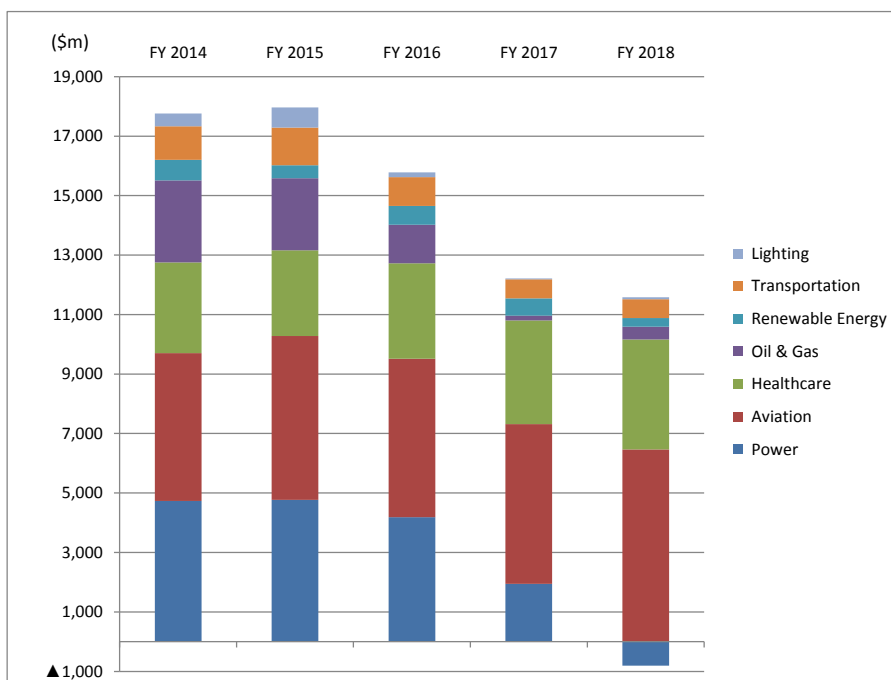
Power segment had disappointing results in FY18. Revenues decreased 22% to \$27.3bn, operating profit turned into -\$808m losses and segment free cash flow became -\$2.7bn. With the sharp drop in revenues, Power fell from the top to the second largest segment with a share of 24% in total revenues. There are three main reasons behind the poor performance. The first one is overcapacity in the gas turbines industry resulting in lower utilization of GE equipment, lower market penetration and increased price concessions on certain long-term contracts. The second reason is non-operating headwinds like pension contributions, legal settlements, some of which are related to Alstom acquisition. The third one is execution issues in Gas Power Systems. During the third quarter of 2018, GE reported oxidation issues within the HA and 9FB Stage 1 turbine blades, resulting in increased warranty and maintenance reserves.

Chart 1: Revenues breakdown by business segment (December 2018)


Source: Company materials, Bloomberg; compiled by Daiwa.

Chart 2: Power Revenues and operating margins


Source: Company materials, Bloomberg; compiled by Daiwa.

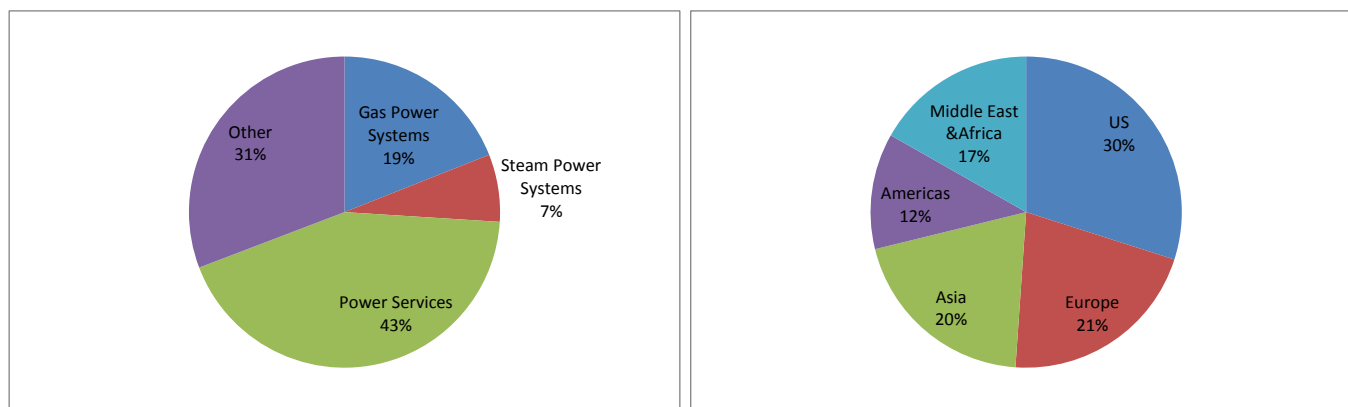
Chart 3: Operating Income by business segment


Source: Company materials, Bloomberg; compiled by Daiwa.

Power has four main sub-segments: Power Services (43% share in Power revenues) Gas Power Systems (19%), Steam Power Systems (7%) and Other (31%). Other includes Grid Solutions, Power Conversion, Automation&Control, GE Hitachi Nuclear and Industrial Solutions until its disposition in the second quarter of 2018. GE announced their intention to reorganize the businesses within Power segment into GE Gas Power and Power Portfolio, and to eliminate the Power headquarters structure in order to reduce costs and improve operations. The reorganization is expected to be completed by the second half of 2019. Upon completion, GE Gas Power will combine Gas Power Systems and Power Services businesses, while Power Portfolio will comprise Steam Power Systems (including services currently reported in Power Services), Power Conversion and GE Hitachi Nuclear businesses. Grid business will be moved to Renewables to take advantage of revenue and cost synergies.

Power revenues have a good geographical diversification with US having the largest share at 30% (see the charts below).

Chart 4: Power Revenues breakdown by sub-segment/ geography as December,2018



Source: Company materials, Bloomberg; compiled by Daiwa.

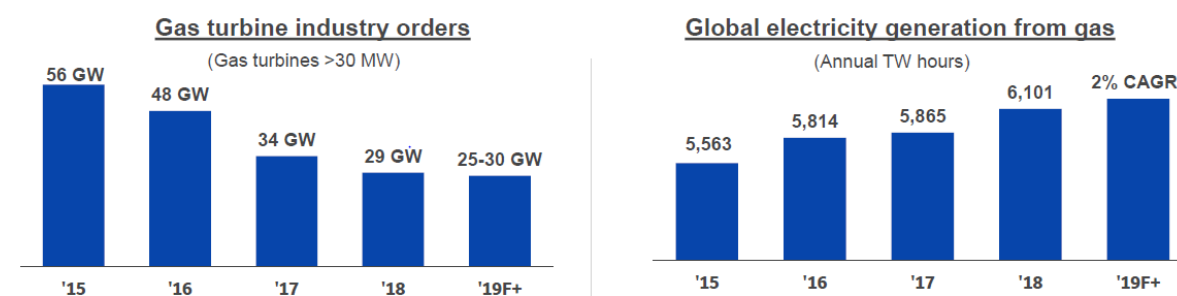
Forward guidance

GE assumes a flat gas turbine market and expects Power's revenues to decrease high single-digits in 2019. Margins are expected to turn positive driven by project bookings and cost reductions. Free cash flows should be down from a negative \$2.7bn in 2018 due to progress collections headwinds, increased project costs and restructuring costs. Free cash flows should improve in 2020 but still in negative territory and should turn positive in 2021.

In the short term, we believe GE has enough valuable assets to absorb negative cash flows from power. Aviation and Healthcare have a strong market position and a healthy cash flow conversion. In FY18, operation income in Aviation segment was up 20% to \$6.5bn and operating income in Healthcare unit (including BioPharma) increased 6% to \$3.7bn. GE is targeting to close BioPharma sale in fourth quarter 2019 and is planning to sell down Baker Hughes in an orderly manner. GE' cash, cash equivalents and restricted cash totaled \$35bn as December 2018.

In the long term, a change in the corporate mind set to focus on cash flow generation and a strict cost management are key factors to a turnaround as the gas power market is negatively affected by cyclical and secular trends. We have already seen some improvements in cash collections in the fourth quarter 2018 as GE moves responsibility for collections closer to the customer relationship managers. We believe a timeframe of three years to turn Power into positive free cash flows is a reasonable and achievable target as we expect earnings recovery mainly due to cost reductions, better management of working capital and a decreasing pressure from the legacy costs over time. We will monitor closely further developments.

Chart 5: Trends in gas turbine industry



Source: Company materials

Chart 6: Power free cash flows

(\$ in billions)		
	2018	2019F+
Working Capital	Income + depreciation	\$0.7
	Progress collections	(1.5)
	AR/Inventory/AP	0.6
Other Operating	Contract assets	0.5
	Project costs	(0.9)
	Restructuring	(0.7)
	Tax/pension	(0.9)
	Capex	(0.5)
	Free cash flows*	(2.7)

- **Income + depreciation:** continued earnings growth from equipment margin recovery & cost out actions
- **Progress collections:** headwinds decline significantly in 2019
- **AR/inventory/AP:** supply chain finance program transition creates a headwind through 2020
- **Contract assets:** continued headwind from run off of long-term receivables factoring program through 2021
- **Project costs:** reduction in new volume; stabilizes in 2020
- **Restructuring:** remains high through 2020; significant reduction in 2021
- **Tax/pension/other:** Alstom UK pension contributions through 2022; expected legal settlements in 2019, smaller in 2020
- **Capex:** in line with 2018

Free cash flows down in 2019, significant improvement in 2020, positive in 2021

Source: Company materials

*Non-GAAP measure

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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

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[Fitch]

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- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥ 2 million (including tax) per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

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