Recommendation: BUY **Target Price until (12/31/2017): $132**

1. Reasons for the Recommendation

Honeywell faces many challenges during the next year. The dollar continues to remain strong relative to other currencies, adversely affecting international sales. Also, growth in the global supply of oil will continue to outpace demand, driving down the price of many of Honeywell's crude oil benchmarked product offerings in the PMT segment. However, despite sluggish global economic growth and the current state of the oil and gas industry, there are many reasons why Honeywell will outperform its competitors through 2017. Through their companywide management software titled Honeywell Operating System (HOS) Gold, Honeywell has achieved efficiency and cost synergies throughout its diverse portfolio of assets. This has become the main catalyst through which Honeywell continues to expand its operating margin. Secondly, Honeywell has a long history of making profitable acquisitions and divestitures that fit the strategic direction of its business segments. Finally, Honeywell's commitment to continued dividend growth while maintaining disciplined capital allocation offers a better risk/return investment than its other peers in the industrial sector. For these three reasons, I recommend a buy rating for the stock.

Margin Expansion

Honeywell has seen tremendous growth in its margins over the past 5 years. Gross profit margin has increased from 21.83% in 2011 to 30.67% in 2015 while net income margin has increased from 5.66% in 2011 to 12.36%.[1] More importantly, segment profit has increased across all three business segments for the same period. Despite a 10% decrease in revenue for 2015, the PMT segment reported a 10% growth in segment operating profit from 2014. Similarly, the Aerospace and ACS segments saw operating segment profit increases of 8% and 9% respectively.[2] Honeywell's main self-identified competitors are General Electric, Emerson, 3M, and United Technologies, and Honeywell has outpaced each in EPS Compounded Annual Growth Rate (CAGR) since the purchase date.[3]

Also factoring in to my recommendation are the results from Honeywell's first quarter earnings report for 2016. Honeywell reported decreased margins from the previous quarter and Q1 in 2015. I believe the decreased margins were caused by volatile raw materials pricing and the effect of bringing recent acquisitions into the fold. These effects will dissipate over the short term horizon and an opportunity currently exists to purchase the stock at a discount. With Dave Cote expected to retire next year, I believe his hand-picked successor, former PMT CEO Darius Adamczyk, will continue to steer Honeywell its current path of increased efficiency and productivity. I expect margins will continue to grow during the next quarter and through 2017. Depending on margin growth throughout this period, margins growth may stagnate over the long term horizon. At that time, Honeywell will lose a key advantage over competitors and will have to cut back on acquisitions and shareholder payout growth.

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[1] Analysts' own calculations. Basic data from Honeywell 10k
[2] Data from Honeywell 10k
[3] Analyst's own calculations, Basic data from Morningstar.

Profitable Acquisitions and Divestitures

Honeywell has a long history of profitable acquisitions relating to the strategic initiatives of each of its operating segments. Past acquisitions such as UOP and Novar Controls, and recent acquisitions such as Thomas Russel, Intermec, and Elster perfectly display the process by which Honeywell researches, values, and integrates their acquisitions. Each acquisition gives Honeywell new technology they can use to expand their product's capabilities, especially their main overall product of control systems used in industrial processes, aerospace, and building control. Also, Honeywell is not opposed to divesting less profitable assets which do not quite fit their strategic goals. In 2014, Honeywell divested its Friction Materials business from the Transportation Systems/Aerospace segment, which netted an overall increase in segment profit of 2%. Essentially, they divested an asset and still managed to increase segment profit from the previous year.[4]

Perhaps more important to making smart acquisitions is Honeywell's ability to leverage such acquisitions with its healthy capital structure. Honeywell continues to have industry leading figures in ROC and ROE. These figures will increase due to Honeywell's new repurchasing program reducing shareholder equity and continued revenue and margin growth leading to increasing returns. Honeywell's large reserve of cash and their forecasted increasing cash flows will give Honeywell the ability to proceed with their repurchase plan, to maintain their planned dividend growth and capex, and to make small to medium opportunistic acquisitions in the future. I expect Honeywell will likely have to issue more long term debt if they wish to finance larger acquisitions similar to the Elster deal or a large merger similar to in scale to the proposed United Technologies Merger. Despite their A credit rating, this could create difficulties for their plans regarding future capex, share repurchases, dividends, and acquisitions.

Sustained Shareholder Returns

Honeywell's capital structure and commitment to dividend growth sets it apart from other industry peers. Currently, the portfolio's Honeywell shares have an HPR of 241% from the time of purchase compared to an HPR of 113% for the S&P 500 and 132% for the XLI Industrial ETF for the same period. At my forecasted dividend growth and target price, the HPR for Honeywell will increase to 299%.[5] Combined with Honeywell's low beta relative to industry peers, this stock offers a very good risk/return ratio. As stated before, Honeywell has the appropriate capital structure to maintain dividend growth. There is little risk associated with Honeywell's continued dividend growth relative to its industry peers.

Buy over Hold

I do not believe the current difficulties facing Honeywell will continue to affect them in the intermediate term. Current unfavorable foreign currency translation conditions will begin to normalize towards the end of 2016 and I expect the price of crude oil to reach an equilibrium of $50-$60 for the next two years. Since Honeywell has weathered the current conditions well while maintaining potential for continued margin expansion, profitable acquisitions, and shareholder return, I am recommending a buy over a hold rating.

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[4] Data from Honeywell 10k
[5] Analysts own calculations. Data from Yahoo Finance as of 4/12/2016

2. Company Analysis

Honeywell's main strength as a company is its diverse portfolio with holdings in many different industries. This allows Honeywell to weather adverse economic conditions well relative to industry peers. For example, Honeywell's position in the oil and gas industry is hedged in a way to its holdings in the aerospace industry. Cheap crude oil prices negatively impact the PMT segment but low fuel costs increase the demand for air travel as potential passengers are better able to afford airline travel. Airlines are able to take advantage of lower fuel costs by expanding their margins and generating cash flows that will be used for upgrading and expanding their current fleets, thus increasing Aerospace revenue. Also, Honeywell's wide range of industrial products and services place the company in a prime position to take advantage of industrial growth in emerging markets. Its ACS and PMT segments offer many products and services related to control of commercial and industrial processes. Demand for crude oil in developing nations will increase catalyst demand in those countries and continued commercial, industrial and residential growth will bode well for the building solutions and process solutions divisions in ACS and PMT.

Honeywell's reliance on growth in emerging markets to meet its revenue and earnings trajectories is also a weakness. While I believe emerging markets will see growth rates rise in the intermediate term, if growth remains sluggish for long enough Honeywell will miss earnings estimates which is always something shareholders react negatively towards. Honeywell also has many suppliers in emerging markets and the stability of those suppliers and the political climate in which they operate exposes Honeywell to inherently higher risk. Also, Honeywell has stakes in both defense and the oil and gas industry. US defense spending is projected to decline while defense spending in emerging markets is subject to the economic performance of those markets. Honeywell's exposure to the oil and gas industry has been profitable for Honeywell over the years but its large stake in the industry relative to other industrial peers gives it greater exposure to the inherent volatility of the industry. However, they have more exposure to the downstream side of the industry which tends to be less volatile.

Several current market conditions present opportunities for Honeywell in the short to intermediate term. The current global economic condition and associated exchange rates will allow Honeywell to make value acquisitions of international companies. Honeywell stated in their latest fourth quarter earnings call that they will look to deploy an additional $20 billion in capital for mergers and acquisitions if they find the right buy. I predict Honeywell will make 1-2 more acquisitions comparable to the Elster acquisition provided the right financing conditions exist. Other opportunities for Honeywell arise from industry conditions. Mergent predicts passenger flight hours will increase by 5% in 2016 creating demand in its Aerospace segment. IBISWorld predicts commercial construction revenues will increase an annualized rate of 3.7%. World population growth and growth in per capita income will continue to fuel growth in residential construction. Growth in both of those sectors will benefit the ACS segment. Finally, growth in demand for crude oil products as well as careful management of supply by producers will cause the price of crude oil to stabilize, leading to sustained growth in the PMT segment.

The primary threats to Honeywell relate to its ability to conduct international sales. Negative effects of currency translation have already reduced its sales. If these effects take too long to normalize, it can cause stagnant revenue growth. If current oil and gas production companies can't agree to curb supply, the price of crude oil can remain low for an extended period of time. The industry has made significant gains over the past month and another crash to a sub $30 price will negatively Honeywell relative to their peers. Along with the inherent risk in the oil and gas industry, many analysts have estimated a 20%-30% risk for another global recession. While Honeywell is equipped to weather a recession with their current diverse portfolio, they are ill equipped to depend on the US and Eurozone to create growth.

3. Industry Analysis

Due to Honeywell's diverse portfolio, they are involved in many different industries with varying amounts of competitors in those industries. Their position in the aerospace industry involves the manufacture of aircraft parts and providing aftermarket services for those parts. This includes both defense and commercial aviation. While they have a relatively small amount of competition in this industry, their competition includes established industrials with large pools of capital such as GE, and United Technologies. Honeywell's proposed merger with United Technologies would have given the combined company tremendous market share for certain aircraft parts as well as annual revenues of up to $90 billion. The outlook for the commercial aviation industry is good with low fuel cost and increased passenger flight hours driving demand for additional aircraft and upgrades to existing aircraft. However, they will focus on expanding their fleet with smaller capacity aircraft in order to maximize revenue per seat mile. Industry annualized revenue growth is projected to be approximately 4.1% from 2016 to 2020. US defense spending is projected to decrease but will be offset by a projected annualized increase of 3.9% increase in emerging market defense spending for 2016 to 2020. Also, the current trend of increased fuel efficiency in personal and commercial vehicles is expected to fuel growth in the turbocharger industry at a rate of 8.8% annual for 2016-2020.

Honeywell's ACS segment is involved in more specific industries than any other segment. Their key competitors in this area include 3M, Johnson Controls, and Siemens. Several of the smaller industries in which ACS is involved have additional smaller competitors. The main competitors primarily compete with Honeywell in their Building Solutions and Distribution section. Recently Johnson Controls merged with Tyco, increasing their market share in the building controls industry. This industry is driven by the residential, commercial, and industrial construction industries. The outlook for these industries include 1.9%, 3.7%, and 1% annualized growth rates for residential, commercial, and industrial construction, respectively. However, in addition to industry growth, there has been an increased emphasis on green construction, driving demand for smart meters and increased building control. This is why the Elster acquisition fits so seamlessly with the strategic direction of ACS. Also, the Xtralis acquisition allows Honeywell to bundle the attractive home security element into its building control systems. Combined with their expertise in climate and energy building control, this will give Honeywell an edge over competitors who entered the building control solutions industry through expanding their home security offerings to include these services.

Honeywell's PMT segment competes in the petrochemical manufacturing industry, and the petroleum refining industries through its UOP, advanced materials, and process solutions divisions. Their key competitors in these industries include several established companies such as Dow, Dupont, Emerson, and the Chinese company Sinopec. Much like in the Aerospace industry, Honeywell competes with companies who have large market shares and large pools of capital. Despite the competition with established players in those industries, Honeywell has capitalized on the growth of both industries, current conditions notwithstanding. Petroleum refining is expected to grow at a rate of 3.1% for from 2016 to 2020 while petrochemical manufacturing is expected to grow at 3.6 annual for the same period. I expect Honeywell to outperform the growth rates in the major industries in which it is involved due to its disciplined capital deployment strategy and the natural synergy that exists within its portfolio, namely due to software solutions emphasized in control of aircraft, buildings, and industrial processes.

Appendix: Inputs into valuation using multiples

	2011	2012	2013	2014	2015	2016F	2017F	2018F
Stock Price using P/E	$ 55.26	$ 59.33	$ 80.11	$ 93.85	$ 102.84	$ 123.39	$ 140.68	$ 150.38
Stock Price using P/S	$ 55.26	$ 59.33	$ 80.11	$ 93.85	$ 102.84	$ 119.16	$ 131.99	$ 145.43
Stock Price Using EV/EBIT	$ 55.26	$ 59.33	$ 80.11	$ 93.85	$ 102.84	$ 129.98	$ 142.07	$ 157.44
Stock Price Using EV/EBITDA	$ 53.98	$ 59.03	$ 79.26	$ 93.89	$ 102.24	$ 118.11	$ 147.93	$ 145.64
Stock Price Using EV/Sales	$ 55.26	$ 59.33	$ 80.11	$ 93.85	$ 102.84	$ 126.58	$ 143.91	$ 163.10
Cash	$ 3,698.00	$ 4,634.00	$ 6,422.00	$ 6,959.00	$ 5,455.00	$ 5,000.00	$ 4,500.00	$ 4,000.00
Sales	$36,529.00	$37,665.00	$39,055.00	$40,306.00	$ 38,581.00	$ 40,604.91	$ 42,424.96	$ 44,168.76
Sales Per Share (basic)	$ 46.78	$ 48.14	$ 49.66	$ 51.38	$ 49.48	$ 54.16	$ 57.39	$ 60.60
EBIT	$ 2,574.00	$ 4,156.00	$ 5,501.00	$ 5,831.00	$ 6,828.00	$ 7,777.79	$ 8,803.18	$ 9,385.86
EBITDA	$ 3,531.00	$ 5,082.00	$ 6,490.00	$ 6,755.00	$ 7,711.00	$ 8,866.18	$ 10,072.64	$ 10,843.83
EPS (basic)	$ 2.65	$ 3.74	$ 4.99	$ 5.40	$ 6.11	$ 7.52	$ 8.68	$ 9.40
MVE	$43,150.91	$46,419.79	$62,994.57	$73,615.94	$ 80,194.63	$ 89,330.80	$ 97,577.40	$106,005.03
Debt	$28,906.00	$28,788.00	$27,856.00	$27,667.00	$ 30,898.00	$ 28,840.35	$ 30,133.07	$ 31,371.64
Enterprise Value	$68,358.91	$70,573.79	$84,428.57	$94,323.94	$105,637.63	$112,464.16	$121,747.68	$131,168.79
P/E	20.9	15.9	16.1	17.4	16.8	16.40	16.20	16.00
P/S	1.2	1.2	1.6	1.8	2.1	2.2	2.3	2.4
EV/EBIT	26.56	16.98	15.35	16.18	15.47	16.00	15.50	16.00
EV/EBITDA	19.07	13.84	12.91	13.97	13.64	13.00	14.00	13.00
EV/Sales	1.87	1.87	2.16	2.34	2.74	3.00	3.25	3.50

** Analyst's own calculations. Source of basic data: company's 10-K; Yahoo! Finance*

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