



## AAON, Inc. (AAON)

**Reduce 2017-2018 EPS Estimates As We Temper Expectations For AAON's New WHP Business; Introduce 2019 Estimates; Maintain NEUTRAL Rating Primarily On Valuation, With \$35 Price Target**

	2016		2017E		2018E		2019E	
		OLD	NEW	OLD	NEW	OLD	NEW	
Mar.	\$0.20	\$0.19A		\$0.26	\$0.25		\$0.30	
June	0.27	0.26A		0.36	0.33		0.39	
Sep.	0.28	0.29	0.28	0.40	0.36		0.42	
Dec.	0.21	0.26	0.25	0.37	0.31		0.35	
<b>EPS</b>	<b>\$0.96</b>	<b>\$0.99</b>	<b>\$0.98</b>	<b>\$1.40</b>	<b>\$1.25</b>		<b>\$1.46</b>	
P/E			35.5x		27.8x		23.8x	
<b>EBITDA (mil)</b>	<b>\$92.6</b>	<b>\$93.4</b>	<b>\$92.7</b>	<b>\$130.1</b>	<b>\$118.3</b>		<b>\$135.1</b>	
EV / EBITDA			19.4x		15.2x		13.3x	

Note: 2016-2019E include stock-based compensation expense of \$0.08, \$0.11, \$0.13, and \$0.15, respectively. Sum of quarterly EPS may not equal full-year total due to rounding and/or change in share count. The Russell 2000 Index includes AAON. NC=Not covered by Sidoti & Company, LLC.

Year	2010	2011	2012	2013	2014	2015	2016	2017E	2018E	2019E
Rev.(Mil.)	\$244.6	\$266.2	\$303.1	\$321.1	\$356.3	\$358.6	\$384.0	\$402.1	\$462.8	\$523.4
GAAP EPS	\$0.38	\$0.25	\$0.49	\$0.68	\$0.80	\$0.84	\$0.96	\$0.98	\$1.25	\$1.51

**Description:** AAON, Inc. (www.aaon.com) is a leading domestic manufacturer of standard and custom heating, ventilating and air conditioning (HVAC) units, including unitary rooftops, chillers, air-handling units, make-up air units, heat recovery units, condensing units, coils and boilers. Products target the nonresidential market, specifically planned replacement (55%) and new construction (45%). AAON generates almost all revenue from the U.S. Headquarters are in Tulsa, OK.

Release Date	Conference Call	Time (Eastern)	Contact	Co. Guidance	Consensus
Early November	TBA	TBA	TBA	N/A	\$0.29

- We reduce our 2017 and 2018 EPS estimates to **\$0.98** (from **\$0.99**) and **\$1.25** (from **\$1.40**), respectively, as we temper our expectations on how fast AAON's new water source heat pump (WHP) business ramps up.
- We also introduce an EPS estimate for 2019 of **\$1.46**, which implies 17% growth and assumes the WHP business gains more than a 10% share (from nothing at the beginning of 2017).
- We forecast 3Q:17 revenue grew 7% to \$112 million and EPS were flat at **\$0.28**. The respective consensus forecasts are \$112 million and **\$0.29**.
- We forecast solid revenue and EPS growth through 2019 assuming end-markets accelerate and the WHP business gains market share. However, we think Street expectations are lofty, especially for 2018; thus, we think EPS misses and downward estimate revisions are likely in the near term.
- Trading at respective 12-month forward P/E and EV/EBITDA multiples of 32x and 17x, compared to peer Lennox International (NYSE: LII, NC) at 21x and 14x, we think the shares are fully valued.
- We maintain a **NEUTRAL** rating and **\$35** target. This target is now based on 24x our 2019 EPS estimate of **\$1.46**, which equates to 13x our 2019 EBITDA estimate of **\$135** million. (Previously, we applied a 25x multiple to our prior 2018 EPS estimate of **\$1.40** to derive the same target.) We lowered our valuation multiple to reflect the longer time horizon out to 2019.

**We reduce our 2017-2018 EPS estimates based on tempered expectations for AAON's new WHP business.** Although we are optimistic about the WHP business, we now think the business will ramp up slower than we originally expected. In the last year, management said about 20% of the \$550 million water source heat pump market was vulnerable and that it expects to take that share quickly after establishing new production lines and receiving certain product certifications. However, after talking to the company in the last few months,

**NEUTRAL**

Price Target: **\$35**

Price: **\$34.80**

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### Key Statistics

Analysts Covering	3
Market Cap (Mil)	\$1,830
Enterprise Value	\$1,798
52-Week Range (NASDAQ)	38-27
5-Year EPS CAGR	20%
Avg. Daily Trading Volume	141,000
Shares Out (Mil)	52.604
Float Shares (Mil)	40.767
Insider Ownership	25%
Institutional Holdings	60%
Annualized Dividend	\$0.26
Dividend Yield	0.7%
FCF Per Share (2019E)	\$1.29
FCF Yield (2019E)	3.7%
Net Cash Per Share (2019E)	\$1.01
Price to Book Value	8.4x
Return on Equity (2019E)	17.3%
Total Debt to Capital	Nil
Interest Coverage Ratio	N/A
Short Interest %	7.6%
Short Interest Days To Cover	23.2
Russell 2000	1,508
Russell 2000 – Last 12 Months	20.5%
AAON – Last 12 Months	20.7%



Source: FactSet Prices

we still think achieving a 20% share is doable, but will take longer than by the end of 2018. Previously, we modeled the company would achieve \$63 million of WHP revenue in 2019, which we estimated translated into about \$0.18 per share of earnings. Now, we model this business will generate \$25 million of revenue in 2018 and \$50 million in 2019, and EPS of \$0.04 and \$0.10, respectively.

**We now project EPS of \$0.98 (from \$0.99) in 2017 and \$1.25 (from \$1.40) in 2018, and introduce an estimate of \$1.46 in 2019.** In addition to the WHP estimates, we project solid growth from of the core business. We model core revenue growth (excluding the WHP contribution) of 7% in 2H:17, 10% in 2018 and 7% in 2019. Historically, incremental margins, on average, were around 45%. We model incremental margins of 52% in 2018 and 37% in 2019. While we think the outlook is positive, we do not think there is much upside to these estimates.

**We forecast a slight EPS miss when AAON reports 3Q:17 results next month.** We forecast quarterly revenue grew 7% to \$112 million and EPS were flat, year over year, at \$0.28. The consensus forecasts are \$112 million and \$0.29, respectively. The one unclear thing is how orders progressed through the quarter. Backlog at the end of June was up 20%, compared to the same month in 2016. Orders and revenue in 3Q:16 were up 10% and 11%, respectively. Therefore, the comparison is tough. The company dealt with rising material costs this year though, which we expect pressured margins. Also, while we expect most of the temporary operating inefficiencies experienced in 1H:17 ended in 3Q:17, we think some lingering issues continued in the quarter. We project the core business achieved 5% revenue growth and 9% earnings growth. We estimate the WHP business operated at a slight loss in the quarter.

<b>Exhibit 1: AAON, Inc. 3Q:17 Variance Analysis</b>			
	<u>3Q:17 Estimate</u>	<u>3Q:16 Actual</u>	<u>YoY Change</u>
Revenue (thou.)	\$111,796	\$104,568	6.9%
Gross profit	35,105	33,092	6.1%
<i>Profit margin</i>	31.4%	31.6%	
Operating income	23,386	22,692	3.1%
<i>Profit margin</i>	20.9%	21.7%	
Adjusted net income	\$14,974	\$14,082	6.3%
<i>Profit margin</i>	13.4%	13.5%	
Adjusted EPS	\$0.28	\$0.26	7.1%

Source: Sidoti & Co., and Company reports

**We maintain a NEUTRAL rating and \$35 target.** Following a near-term recovery in the shares after falling when disappointing 2Q:17 results were reported, the stock trades at forward P/E and EV/EBITDA multiples of 32x and 17x, respectively. While AAON justifiably trades at a premium to peer Lennox International, which trades at 21x and 14x, respectively, we think the shares trade close to fair value. Our \$37 target is now based on 24x our 2019 EPS estimate of \$1.46, which equates to 13x our 2019 EBITDA estimate of \$135 million. (Previously, we applied a 25x multiple to our prior 2018 EPS estimate of \$1.40 to derive the same price target.) We lowered our valuation multiple to reflect the longer time horizon. Given the lack of upside implied by the \$35 target, we maintain a NEUTRAL rating.

#### Key Risks

Construction does not improve

Steel and copper prices rise

U.S. recession

AAON, INC.

**Table I. AAON, Inc. Income Statement**

(in thousands, except where noted)

	Mar	Jun	Sep	Dec	2016	MarA	JunA	SepE	DecE	2017E	MarE	JunE	SepE	DecE	2018E	2019E
<b>Sales, net</b>	<b>\$85,422</b>	<b>\$102,319</b>	<b>\$104,568</b>	<b>\$91,668</b>	<b>\$383,977</b>	<b>\$86,078</b>	<b>\$101,326</b>	<b>\$111,796</b>	<b>\$102,918</b>	<b>\$402,119</b>	<b>\$98,686</b>	<b>\$121,512</b>	<b>\$126,678</b>	<b>\$115,912</b>	<b>\$462,787</b>	<b>\$518,432</b>
Cost of sales	59,691	69,572	71,476	65,158	265,897	61,092	69,648	76,691	72,642	280,073	68,508	81,662	84,956	79,947	315,073	351,721
<b>Gross profit</b>	<b>25,731</b>	<b>32,747</b>	<b>33,092</b>	<b>26,510</b>	<b>118,080</b>	<b>24,986</b>	<b>31,678</b>	<b>35,105</b>	<b>30,276</b>	<b>122,045</b>	<b>30,178</b>	<b>39,850</b>	<b>41,722</b>	<b>35,964</b>	<b>147,714</b>	<b>166,712</b>
SG&A	8,913	10,561	10,400	8,632	38,506	10,530	11,971	11,720	9,732	43,953	9,879	12,331	12,294	10,444	44,949	47,584
Other	(8)	(12)	0	0	(20)	(1)	48	0	0	47	0	0	0	0	0	0
<b>Operating income</b>	<b>16,826</b>	<b>22,198</b>	<b>22,692</b>	<b>17,878</b>	<b>79,594</b>	<b>14,457</b>	<b>19,659</b>	<b>23,386</b>	<b>20,543</b>	<b>78,045</b>	<b>20,299</b>	<b>27,519</b>	<b>29,428</b>	<b>25,520</b>	<b>102,766</b>	<b>119,127</b>
<b>Operating income (ex. one-time items)</b>	<b>16,826</b>	<b>22,198</b>	<b>22,692</b>	<b>17,878</b>	<b>79,594</b>	<b>14,457</b>	<b>19,659</b>	<b>23,386</b>	<b>20,543</b>	<b>78,045</b>	<b>20,299</b>	<b>27,519</b>	<b>29,428</b>	<b>25,520</b>	<b>102,766</b>	<b>119,127</b>
Interest expense	(74)	(67)	(82)	(69)	(292)	(60)	(71)	(21)	(50)	(202)	(45)	(48)	(21)	(50)	(164)	(164)
Other (income) expense	(117)	(10)	12	10	(105)	(11)	(34)	10	10	(25)	10	10	10	10	40	40
<b>Income before income taxes</b>	<b>17,017</b>	<b>22,275</b>	<b>22,762</b>	<b>17,937</b>	<b>79,991</b>	<b>14,528</b>	<b>19,764</b>	<b>23,397</b>	<b>20,583</b>	<b>78,272</b>	<b>20,334</b>	<b>27,557</b>	<b>29,439</b>	<b>25,560</b>	<b>102,890</b>	<b>119,251</b>
Income tax provision	6,211	7,934	8,180	6,517	28,842	4,311	5,970	8,423	7,410	26,114	7,320	9,920	10,598	9,202	37,040	42,930
<b>Net Income</b>	<b>\$10,806</b>	<b>\$14,341</b>	<b>\$14,582</b>	<b>\$11,420</b>	<b>\$51,149</b>	<b>\$10,217</b>	<b>\$13,794</b>	<b>\$14,974</b>	<b>\$13,173</b>	<b>\$52,158</b>	<b>\$13,014</b>	<b>\$17,636</b>	<b>\$18,841</b>	<b>\$16,358</b>	<b>\$65,850</b>	<b>\$76,321</b>
<b>Net Income (ex. one-time items)</b>	<b>\$10,806</b>	<b>\$14,341</b>	<b>\$14,582</b>	<b>\$11,420</b>	<b>\$51,149</b>	<b>\$10,217</b>	<b>\$13,794</b>	<b>\$14,974</b>	<b>\$13,173</b>	<b>\$52,158</b>	<b>\$13,014</b>	<b>\$17,636</b>	<b>\$18,841</b>	<b>\$16,358</b>	<b>\$65,850</b>	<b>\$76,321</b>
<b>GAAP Diluted EPS</b>	<b>\$0.20</b>	<b>\$0.27</b>	<b>\$0.27</b>	<b>\$0.21</b>	<b>\$0.96</b>	<b>\$0.19</b>	<b>\$0.26</b>	<b>\$0.28</b>	<b>\$0.25</b>	<b>\$0.98</b>	<b>\$0.25</b>	<b>\$0.33</b>	<b>\$0.36</b>	<b>\$0.31</b>	<b>\$1.25</b>	<b>\$1.46</b>
<b>Diluted EPS</b>	<b>\$0.20</b>	<b>\$0.27</b>	<b>\$0.26</b>	<b>\$0.21</b>	<b>\$0.96</b>	<b>\$0.19</b>	<b>\$0.26</b>	<b>\$0.28</b>	<b>\$0.25</b>	<b>\$0.98</b>	<b>\$0.25</b>	<b>\$0.33</b>	<b>\$0.36</b>	<b>\$0.31</b>	<b>\$1.25</b>	<b>\$1.46</b>
Diluted shares outstanding	53,430	53,401	53,394	53,420	53,411	53,190	53,151	53,031	52,911	53,071	52,791	52,671	52,551	52,431	52,611	52,131
<b>YOY Growth:</b>																
Revenue	11.3%	13.3%	10.8%	-5.7%	7.1%	0.8%	-1.0%	6.9%	12.3%	4.7%	14.6%	19.9%	13.3%	12.6%	15.1%	12.0%
Cost of sales	8.6%	10.2%	11.4%	-3.7%	6.4%	2.3%	0.1%	7.3%	11.5%	5.3%	12.1%	17.2%	10.8%	10.1%	12.5%	11.6%
SG&A	7.2%	14.8%	3.4%	-12.4%	2.9%	18.1%	13.4%	12.7%	12.7%	14.1%	-6.2%	3.0%	4.9%	7.3%	2.3%	5.9%
Gross profit	18.0%	20.8%	9.6%	-10.4%	8.6%	-2.9%	-3.3%	6.1%	14.2%	3.4%	20.8%	25.8%	18.8%	18.8%	21.0%	12.9%
Operating income	24.9%	23.7%	12.6%	-9.3%	11.6%	-14.1%	-11.4%	3.1%	14.9%	-1.9%	40.4%	40.0%	25.8%	24.2%	31.7%	15.9%
Net income	28.7%	28.8%	10.0%	-11.8%	11.9%	-5.5%	-3.8%	2.7%	15.4%	2.0%	27.4%	27.9%	25.8%	24.2%	26.2%	15.9%
Diluted EPS	31.6%	31.9%	8.6%	-10.8%	14.1%	-5.0%	-3.4%	7.1%	16.5%	2.6%	28.3%	29.0%	27.0%	25.3%	27.4%	17.0%
<b>Margin Analysis:</b>																
COGS/sales	69.9%	68.0%	68.4%	71.1%	69.2%	71.0%	68.7%	68.6%	70.6%	69.6%	69.4%	67.2%	67.1%	69.0%	68.1%	67.8%
SG&A/sales	10.4%	10.3%	9.9%	9.4%	10.0%	12.2%	11.8%	10.5%	9.5%	10.9%	10.0%	10.1%	9.7%	9.0%	9.7%	9.2%
Gross profit margin	30.1%	32.0%	31.6%	28.9%	30.8%	29.0%	31.3%	31.4%	29.4%	30.4%	30.6%	32.8%	32.9%	31.0%	31.9%	32.2%
Operating margin (ex. one-time items)	19.7%	21.7%	21.7%	19.5%	20.7%	16.8%	19.4%	20.9%	20.0%	19.4%	20.6%	22.6%	23.2%	22.0%	22.2%	23.0%
Pretax margin	19.9%	21.8%	21.8%	19.6%	20.8%	16.9%	19.5%	20.9%	20.0%	19.5%	20.6%	22.7%	23.2%	22.1%	22.2%	23.0%
Net margin	12.7%	14.0%	13.9%	12.5%	13.3%	11.9%	13.6%	13.4%	12.8%	13.0%	13.2%	14.5%	14.9%	14.1%	14.2%	14.7%
Tax rate	36.5%	35.6%	35.9%	36.3%	36.1%	29.7%	30.2%	36.0%	36.0%	33.4%	36.0%	36.0%	36.0%	36.0%	36.0%	36.0%

Sources: Company reports and Sidoti & Company, LLC estimates

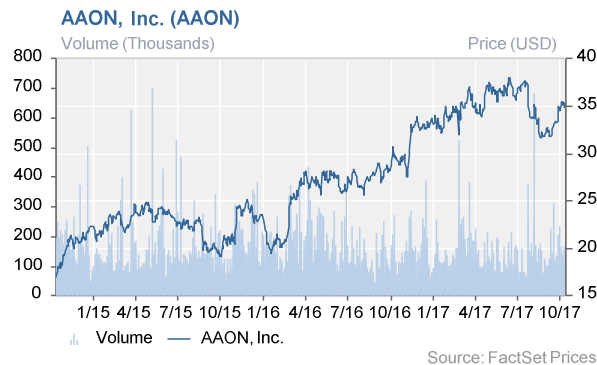
## Appendix Required Disclosures

### Required Disclosures

**AAON, Inc. (AAON-\$34.80) NEUTRAL Price Target: \$35 October 11, 2017**

Rating and Price Target History Table

Action	Date	Px	Rating	PT
Rating	2/6/15	23.7	Neutral	25
PT	8/6/15	21.6		22
PT	10/19/15	21		20
PT	12/17/15	23.4		23
PT	2/25/16	22.4		25
PT	9/16/16	27.6		28
PT	12/16/16	32.6		34
PT	5/4/17	37.2		37
PT	8/3/17	33.8		35



<b>Key Risks</b>	Construction does not improve	Steel and copper prices rise	U.S. recession
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#### Valuation:

**We maintain a NEUTRAL rating and \$35 target.** Following a near-term recovery in the shares after falling when disappointing 2Q:17 results were reported, the stock trades at forward P/E and EV/EBITDA multiples of 32x and 17x, respectively. While AAON justifiably trades at a premium to peer Lennox International, which trades at 21x and 14x, respectively, we think the shares trade close to fair value. Our \$37 target is now based on 24x our 2019 EPS estimate of \$1.46, which equates to 13x our 2019 EBITDA estimate of \$135 million. (Previously, we applied a 25x multiple to our prior 2018 EPS estimate of \$1.40 to derive the same price target.) We lowered our valuation multiple to reflect the longer time horizon. Given the lack of upside implied by the \$35 target, we maintain a NEUTRAL rating.

#### Required Disclosures

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## APPENDIX CONTINUED

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