Heroux Devtek (TSX: HRX)

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Source(s):

Company Overview

Dominant Aerospace Manufacturer Specializing in Landing Gear

Business Overview

- Heroux Devtek is the third largest manufacturer of aerospace landing gear and is responsible for supplying today's leading aerospace OEMs.
- Heroux Devtek was found in 1942 in Longueil, Quebec and began by specializing in machine tooling of aircraft components. In 1960 the firm transitioned into landing gear.
- The company has 16 facilities and 1800 employees across North America and Europe.
- Heroux Devtek operates in two main segments, Defense and Civil. The customers in both segments are similar OEMs, but the end user differs, as governments serve as primary end users in the defense segment.

Management

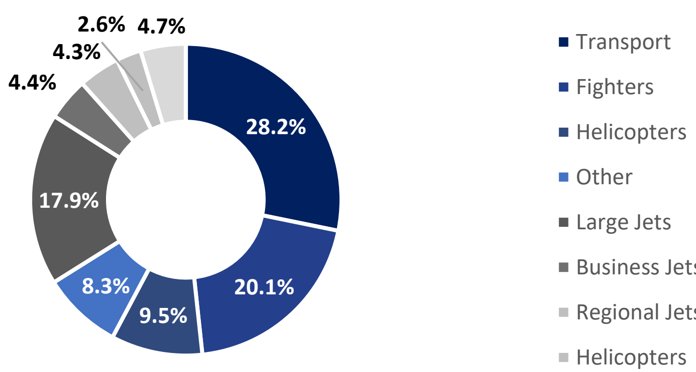
Gilles Labbe – Executive Chairman of the Board. Previously held the position of President/CEO since 2000.

Martin Brassard – President and CEO. Joined HRX in 1994. Previously held the position of VP/COO at HRX.

Stephane Arsenault – VP and CFO. Joined HRX in 1997. Previously held the position of VP/CTO at HRX.

Segmented Revenue

66% Defense / 34% Civil



Competitive Advantage

- The landing gear market is oligopolistic in nature with the three largest firms controlling a large share of the market.
- The landing gear and aerospace market has large barriers to entry in the form of strong existing relationships with OEMs, switching costs, manufacturing expertise, and FAA certification.
- Within the landing gear market, there is a risk/reward trade-off when choosing suppliers that is swayed in the favor of leading manufactures like Heroux Devtek. Most OEMs would not choose an unknown supplier to partner on a mission-critical aircraft even if there may be a slight cost advantage.

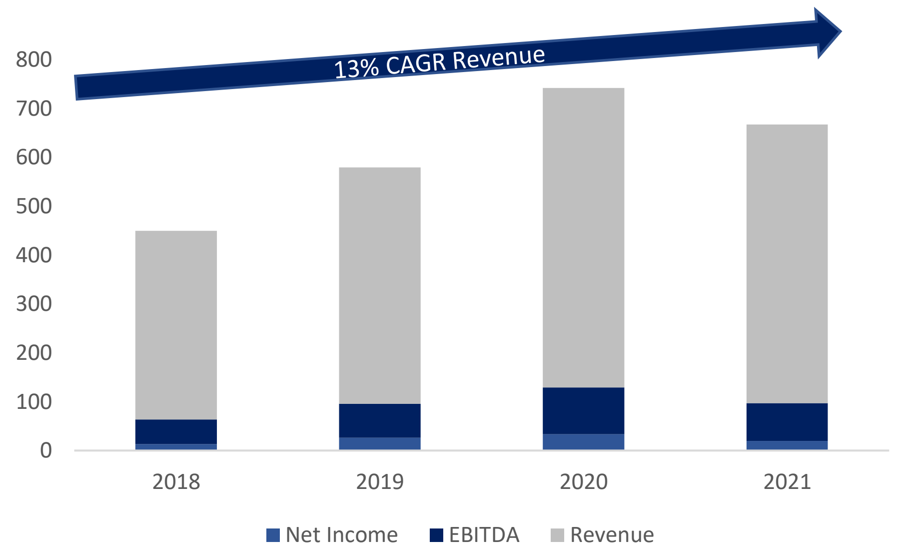
Company Overview

Long-Term Contracts with Major OEMs Contributing to Predictable Revenue Growth

Key Programs

- **Lockheed Martin F35:** Currently supplies door uplock systems for the F35. Recently entered into agreement to supply landing gear for next generation for Lockheed fighters
- **Boeing F15/F18:** Responsible for supplying main landing gear systems for the F15 and F18 fighters. Original agreement was signed in 2018 with an indefinite quantity scope.
- **Sikorsky CH-53K:** Originally signed multi-year agreement in 2007 to supply landing gear and tail bumpers.
- **Boeing 777/777x:** Represents Heroux Devtek's largest civil program. Recently signed a 6-year extension to 2030 to supply complete landing gear systems.

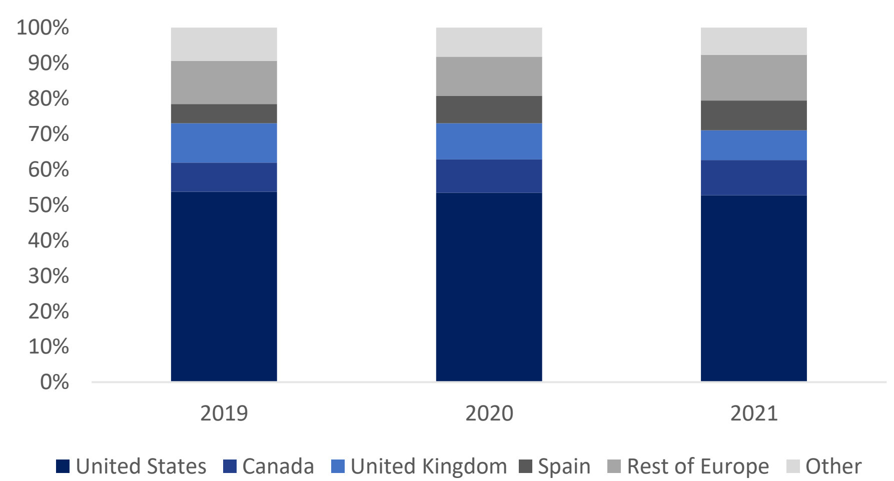
Financial Profile



Key Financial Data

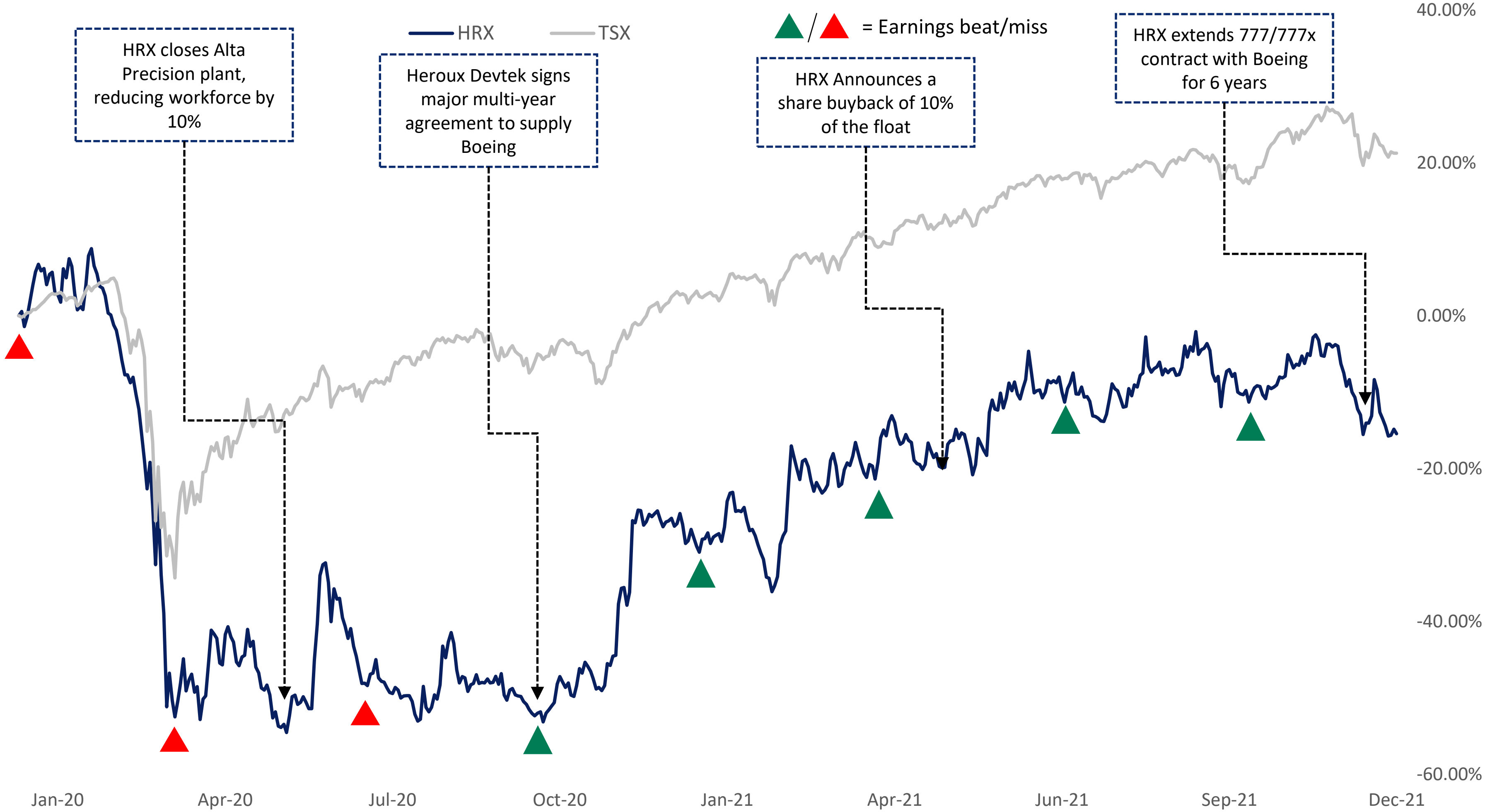
Market Cap:	615M
52 Week Range:	12.45-19.65
% of High	85.3%
EV/EBITDA:	8.2x
P/E:	18.4x
Revenue Growth:	2.9%
EBITDA Margin	15.9x

Geographic Revenue



Annotated Stock Price Chart

HRX's stock has still not recovered to pre pandemic levels

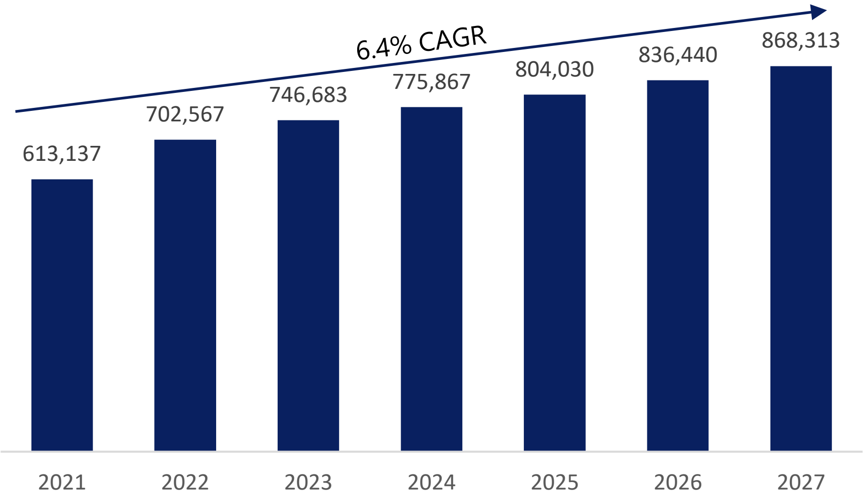


Consistent earnings and a share buyback program indicate strong fundamentals

Industry Overview

Commercial Aerospace and Defense

Commercial Aerospace Manufacturing Revenue ($USD M)



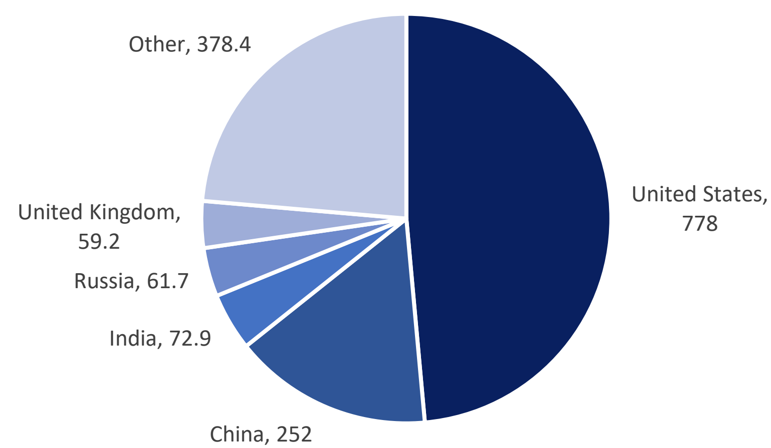
Commercial Aerospace Market Trends

- Average air trip length expected to drop a further 8.5% in 2021 from 2020
- Changes in consumer behavior are likely to drive sales to narrow-body aircraft in the short-medium term
- Passenger traffic will not return to pre-pandemic levels until at least 2023, driven by a 86% decrease in international travel. As a result, airlines will lower aircraft utilization rates, leading to a weak aftermarket for parts and services
- Domestic passenger traffic is projected to reach 96% of pre-covid levels in the second half of 2021; a result of accumulating discretionary income and pent-up pandemic demand
- Total passenger numbers are expected to recover to 43% of 2019 levels by the end of 2021

Defense Aerospace Market Outlook

- Defense is a stable sector; however, governments are coming under pressure to cut back on defense spending to boost their economies out of the pandemic
- Despite the nature of Biden's party, the Democrats plan to increase military spending by 1.5% to $715 billion for the fiscal year of 2022
- Global security environment is becoming increasingly dynamic with Palestine, Russia, North Korea, and China
- An overall shift for some aerospace companies from commercial to defense to weather the pandemic means increased competition in the space
- Major defense spending nations have committed to strengthening their countries military presence with China, India, Japan, and the US increasing defense budgets
- Defense sector has overall pivoted from returning capital to shareholders to investing for future growth

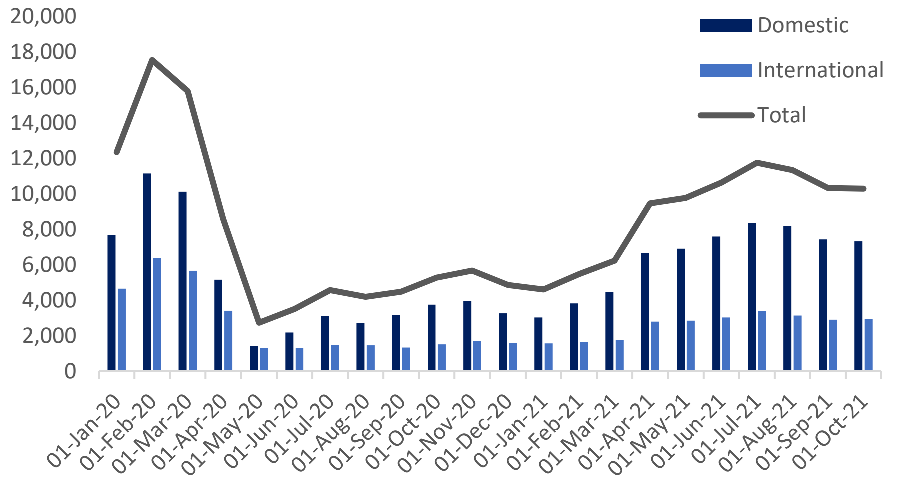
Defense Spending in 2020 ($USD B)



Investment Thesis I: Strong, Delayed Macroeconomic Tailwinds

The Delayed Recovery In The Commercial Aviation Sector Will Boost Sales And Profitability

US Commercial Aviation Transactions (Monthly, 000's)



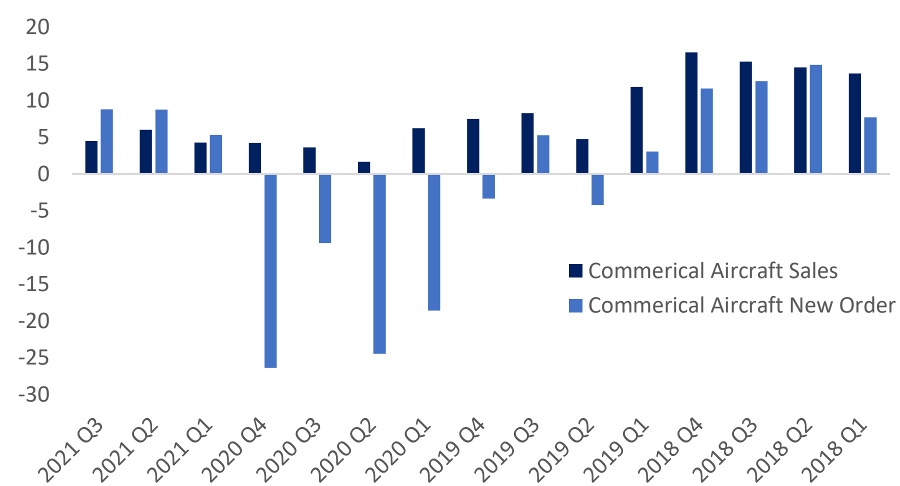
Increasing Demand For Commercial Aviation Services

- Widespread lockdowns and restrictions during COVID-19 were largely not aligned with current air-travel procedures, thus there was a major decrease in commercial aviation travel throughout 2020.
- Systematic removal of domestic restrictions worldwide have renewed consumer demand for travel, however international restrictions remain in place.
- It is anticipated that there is massive pent-up demand for air-travel, both domestically and internationally, on a go-forward basis, specifically within the Millennial/Gen-X age group. Estimates range in the 20-50% above pre-pandemic level for this travel category.

Renewed Commercial Aircraft Orders

- Large cancellation of new commercial aircraft at the beginning of COVID-19 drastically altered the aviation manufacturing stack with a large shift towards defense/military.
- In recent quarters, there has been renewed confidence in the re-emergence of the aviation sector. Boeing has received several new orders for commercial aircraft and is expected to manufacture 4163 new planes by 2025. Airbus has followed a similar trajectory.
- Commercial air fleets worldwide are expected to change on a go-forwards basis, mainly due to ESG considerations and shifting consumer preferences. By 2040, the global fleet is expected to be as large as 49,405 aircraft mostly concentrated in narrow-body builds.
- The Asian Pacific region is expected to see the largest growth, with an estimated 19,150 aircraft by 2040 (~39% of the global fleet).

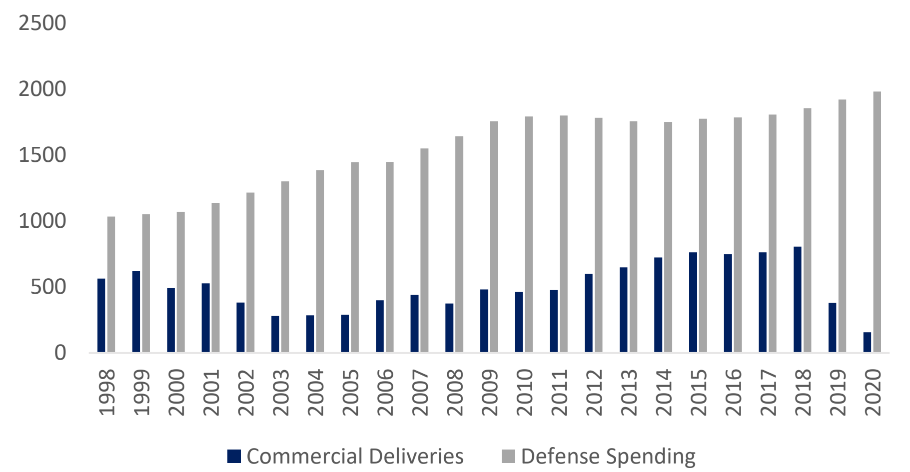
Boeing US Commercial Aircraft Data (Quarterly, B USD$)



Investment Thesis II: Increasing Prominence of Defence Revenue

Strong Results from the Defense Sector Will Protect Cash Flow As Commercial Aviation Recovers

Boeing Aircraft Delivers vs. Global Defense Spending ($USD B)



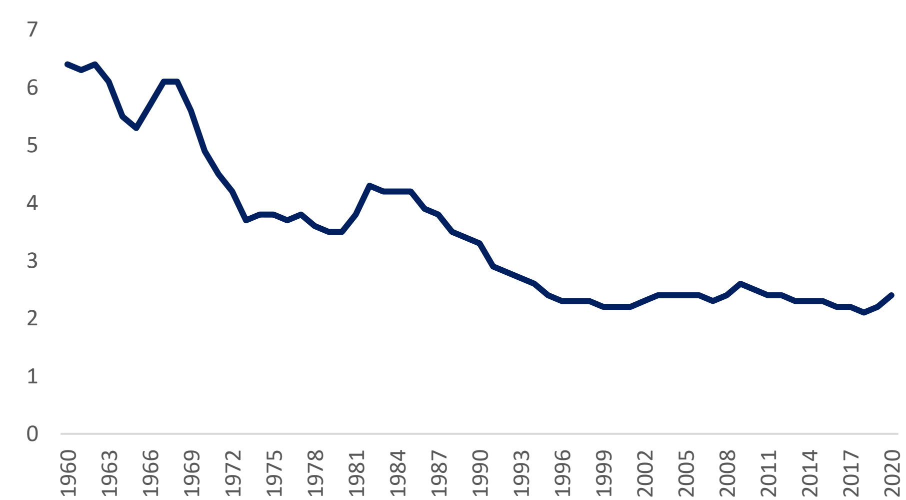
Less Cyclicality in Revenue

- As the commercial sector continues to recover, strong support from the defense segment is keeping cash flow steady.
- In 2018, revenue was split 50-50 between defense and civil sectors. In 2021 the split became 65% defense and 35% civil, resulting in a much greater dependency on defense revenue
- Compared to the civil sector, the defense sector is less susceptible to economic cycles and shocks. Global defense spending rose 2.5% amidst a 4.4% decline in GDP in 2020
- Producing a greater percentage of revenue from the defense sector will allow Heroux Devtek to generate income that is less affected by cyclicality.

Geopolitical Tensions Leading to Higher Defense Spending

- Increasing geopolitical tensions have led to many nations such as the United Kingdom, China, Japan, and Spain signaling increases in defense spending.
- HRX's top European countries continue to increase defense spending. Spain is expected to raise defense spending by 8% in 2022, while U.K's defense spending is projected to continue growing following a massive increase in 2021, fueled by concerns of military weakness.
- Initial fears of a substantial decrease in US defense spending were unfounded, with the US House of Representatives recently approving a $768 million dollar budget for 2022. The bill passed with ease by a vote of 363 – 70.
- Global military spending as a percentage of GDP reached 2.4% representing the largest year over year increase since 2009

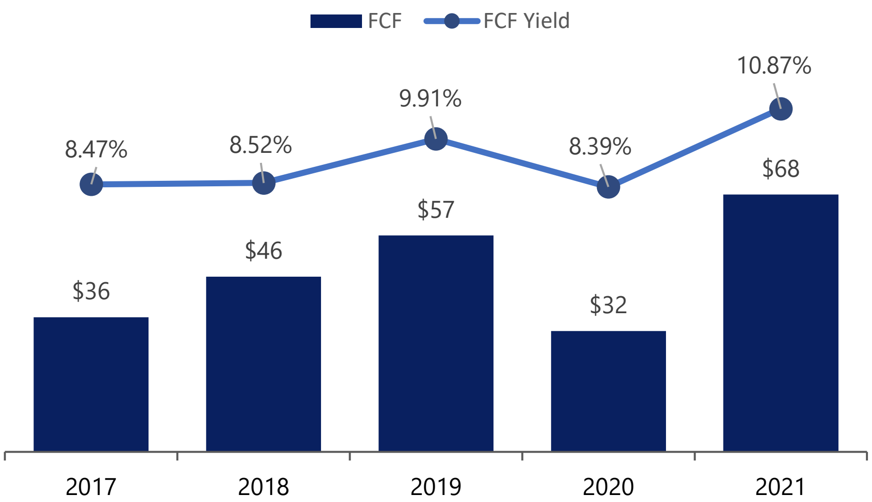
Global Military Expenditure as a % of GDP



Investment Thesis III: Strong FCF Generation Reduces Debt Levels

Reducing Debt to Open Future M&A Opportunities

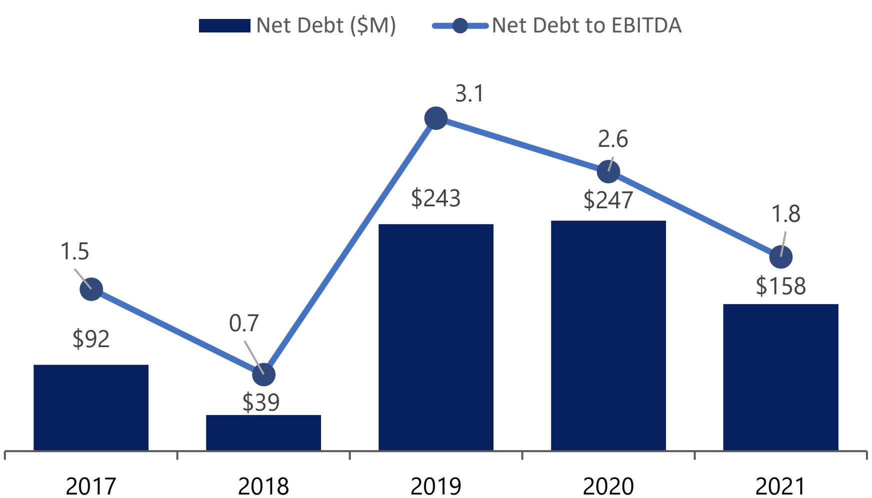
Strong FCF Through Pandemic Times



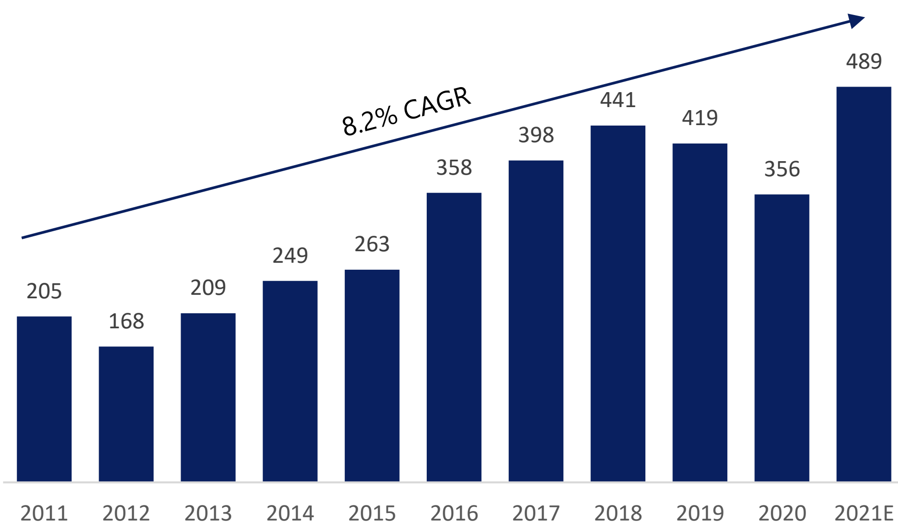
Increasing M&A Activity in Canadian Aerospace

- Canadian domestic Aerospace & Defense (A&D) is reliant on exports; hence, companies are looking to expand their global presence
- The prolonged period of weak commercial air travel is likely to drive increased M&A deals in the small to mid size end of the market
- Heroux Devtek is looking towards Europe to expand their presence in developed markets
- M&A in A&D has shifted from large deals attempting to generate cost savings from economies of scale to deals that give companies access to new markets and new products
- Modernization in the U.S. is encouraged by geopolitical tensions around the world, creating M&A opportunities to innovate

Decreasing Net Debt to Adjusted EBITDA



Number of Deals in A&D



Source(s): Bloomberg, HRX Company Filings, Deloitte, KPMG

INVESTA

Risks and Catalysts

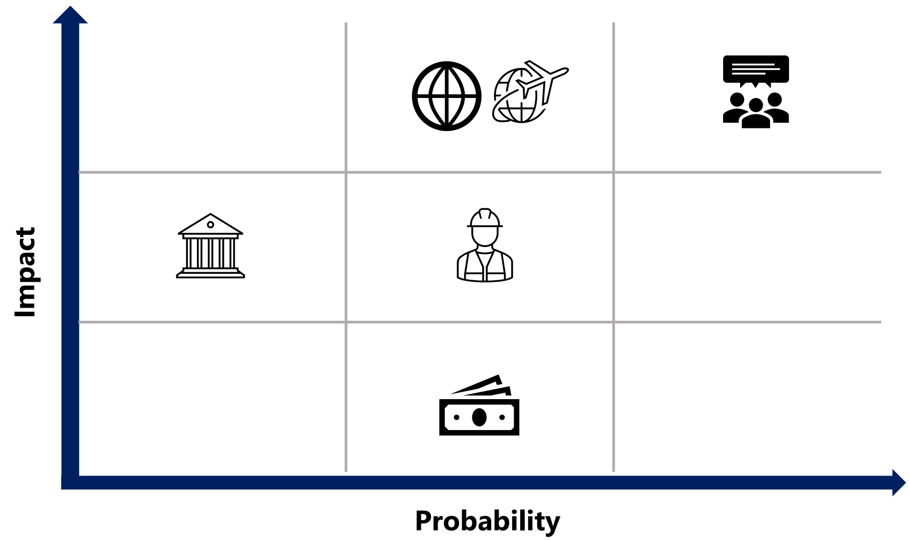
Mitigated risks and attractive catalysts will drive business value moving forward

Risks

Ongoing COVID Travel Restrictions
The persistence of COVID restriction worldwide will have continued impacts on the commercial aviation industry, which limits new aircraft build activity and thus HRX's core business.

Increasing Labor Costs
Skilled labor markets are heating up due to inflation, willingness to work, and population dynamics. This will can affect HRX's margins in the future.

Tight Governmental Budgets
Increasing government debt puts pressures on legislators to cut expenses. One of the first places that many people look is the defense budget, placing HRX's revenue under intense scrutiny.



Mitigations

Ensure Sufficient Client Diversity
HRX is able to effectively shift their business focus from commercial to defense (and vise versa) during times of uncertainty, During COVID, HRX secured a number of defense contracts to cushion earnings.

Stable Revenues
The nature of HRX's revenues are stable, from their equipment manufacturing to their aftermarket revenues.

Expanding Around the World
HRX's management is experienced and understands where the industry is headed. HRX's expansion towards Europe strengthens their top line.

Catalysts

Re-Emergence Of Commercial Air-Travel Industry
The return of commercial air-travel will increase demand for new aircraft, and HRX has built sufficient operational capacity to take on this increased demand.

Acquisition/Contract Activity
Recent acquisition activity in Europe has increase HRX's global presence and operational capacity. In addition, they secured several long-term defense contracts in Europe/USA.

Restructuring Initiatives
Several initiatives launched during the pandemic have reduced HRX's long-term cost structure, as well as altered the capital structure to position the company for stronger value creation.

Strong business fundamentals, industry backdrop and the expertise of management will create value for shareholders

Source(s):

Comparables Analysis

Operating Statistics

Operating Statistics: Company Name	Ticker	Market Data: Share Price	Equity Value	Net Debt	Enterprise Value	Revenue: LTM	FY21	FY22	EBITDA: LTM	FY21	FY22	Net Income: LTM	FY21	FY22	Revenue Growth	EBITDA Growth	EBITDA Margin (LTM)
Triumph Group, Inc.	TGI	17.0	1,409.0	1,415.6	2,824.6	2,082.1	2,471.4	1,936.6	296.3	301.3	228.8	53.8	(2.1)	63.4	-21.6%	-24.1%	12.2%
Circor International, Inc.	CIR	26.5	689.0	543.3	1,232.3	981.6	1,036.9	997.7	108.9	123.0	127.3	(78.9)	(21.0)	53.5	-3.8%	3.5%	11.9%
Safran Landing Systems	SAF	98.5	60,996.5	4,121.0	65,117.5	22,438.4	25,439.4	22,437.5	3,589.0	4,094.8	4,182.4	1,366.0	903.4	1,670.2	-11.8%	2.1%	16.1%
Raytheon Technologies	RTX	83.4	160,400.4	30,006.9	190,407.3	75,879.8	80,612.5	80,170.3	13,623.6	11,290.7	13,054.3	6,918.6	3,472.6	7,898.1	-0.5%	15.6%	14.0%
Magellan Aerospace	MAL	9.9	575.6	31.5	607.1	690.4	744.4	712.5	73.5	80.5	74.7	9.9	(1.2)	12.5	-4.3%	-7.2%	10.8%
Mean						**20,414.5**	**22,060.9**	**21,250.9**	**3,538.3**	**3,178.1**	**3,533.5**	**1,653.9**	**870.3**	**1,939.5**	**-8.4%**	**-2.0%**	**13.0%**
Median						**2,082.1**	**2,471.4**	**1,936.6**	**296.3**	**301.3**	**228.8**	**53.8**	**(1.2)**	**63.4**	**-4.3%**	**2.1%**	**12.2%**
Héroux-Devtek	**HRX**	**16.6**	**595.3**	**145.3**	**740.6**	**568.5**	**570.7**	**587.0**	**90.5**	**77.2**	**89.0**	**32.4**	**32.8**	**34.0**	**2.9%**	**15.3%**	**13.5%**

Valuation Statistics

Valuation Statistics: Company Name	Ticker	Share Price	Equity Value	Enterprise Value	EV/EBITDA: LTM	FY21	FY22	P/E: LTM	FY21	FY22
Triumph Group, Inc.	TGI	17.0	1,409.0	2,824.6	9.5x	9.4x	12.3x	26.2x	NA	22.2x
Circor International, Inc.	CIR	26.5	689.0	1,232.3	11.3x	10.0x	9.7x	NA	NA	12.9x
Safran Landing Systems	SAF	98.5	60,996.5	65,117.5	18.1x	15.9x	15.6x	44.7x	67.5x	36.5x
Raytheon Technologies	RTX	83.4	160,400.4	190,407.3	14.0x	16.9x	14.6x	23.2x	46.2x	20.3x
Magellan Aerospace	MAL	9.9	575.6	607.1	8.3x	7.5x	8.1x	58.1x	NA	46.0x
Mean					**12.2x**	**11.9x**	**12.1x**	**38.0x**	**56.9x**	**27.6x**
Median					**11.3x**	**10.0x**	**12.3x**	**35.4x**	**56.9x**	**22.2x**
Héroux-Devtek	**HRX**	**16.6**	**595.3**	**740.6**	**8.2x**	**9.6x**	**8.3x**	**18.4x**	**18.2x**	**17.5x**
Implied Share Price	**HRX**				**24.1**	**17.3**	**26.1**	**31.0**	**50.4**	**20.5**

Source(s): Bloomberg, Company Filings

Discounted Cash Flow Analysis

Free Cash Flow Projections

Discounted Cash Flow Analysis	Historical				Forecast								
	2018A	2019A	2020A	2021A	2022E	2023E	2024E	2025E	2026E	2027E	2028E	2029E	2030E
EBIT	23.4	37.3	(30.1)	34.1	50.5	52.2	53.9	56.2	57.8	59.4	61.1	62.6	64.1
(+) Depreciation and Ammortization	26.6	32.7	43.6	43.1	38.5	37.0	36.9	37.0	37.4	37.8	38.3	38.9	39.5
(-) Taxes	(7.2)	(4.2)	(12.7)	(6.4)	(10.9)	(11.3)	(11.8)	(12.4)	(12.8)	(13.1)	(13.6)	(14.0)	(14.3)
(-) Capital Expenditures	(9.9)	(12.9)	(20.6)	(21.3)	(26.4)	(27.3)	(28.2)	(29.4)	(30.3)	(31.1)	(32.0)	(32.7)	(33.5)
(-) Changes in NWC	13.5	9.6	(29.5)	22.9	22.0	(3.3)	(3.5)	(4.5)	(3.3)	(3.0)	(3.4)	(3.0)	(3.0)
Unlevered Free Cash Flow	**46.4**	**62.4**	**(49.3)**	**72.4**	**73.7**	**47.2**	**47.3**	**47.0**	**48.9**	**49.9**	**50.4**	**51.7**	**52.8**

Valuation

WACC Calculation	
Debt/Equity Ratio	27.3%
Cost of Equity	8.8%
Market Risk Prenium	6.0%
Risk Free Rate	1.0%
Beta	1.3
Cost of Debt	2.7%
WACC	7.1%

Assumptions

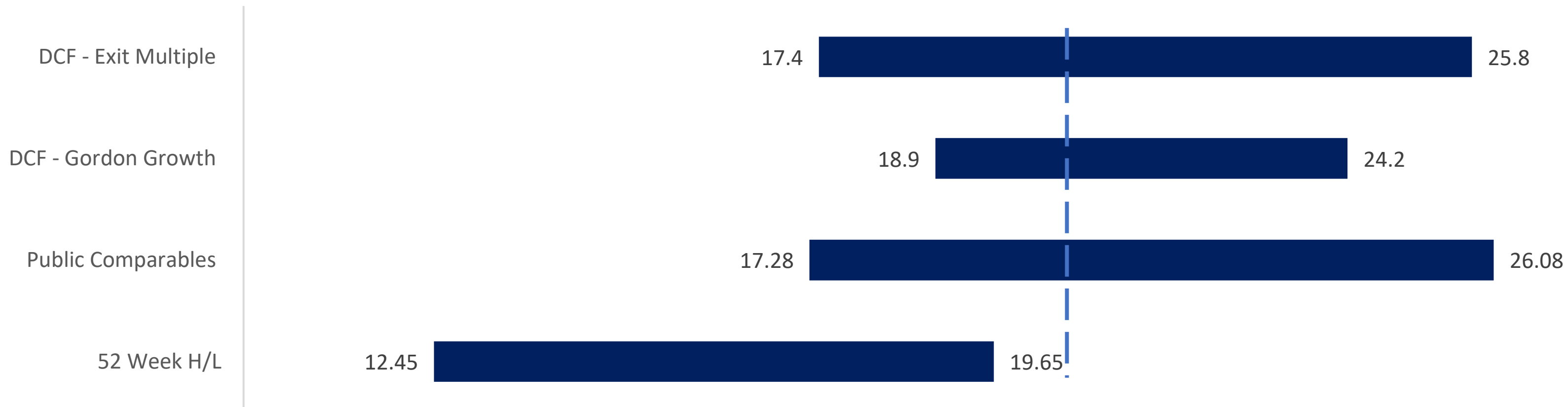
- Revenue was projected by splitting up civil and defense sales. Civil revenue was projected using Boeing's forecasted fleet growth, while defense revenue was forecasted by estimating growth in defense budgets of key countries
- The Current debt/equity ratio was used since management has indicated that they have reached their target debt level

Source(s): Bloomberg, Company Filings

Recommendation: Buy

Blended Valuation based on DCF and Comparables Analysis Implies 22% Upside

Football Field Analysis



Valuation Summary

Valuation Method	Weight	Price
Public Comparables	33%	19.7
DCF - Gordon Growth (2%)	33%	20.8
DCF - Exit Multiple (10x)	33%	20.7
Blended Valuation		20.18
Current Share Price		16.60
Implied Return		22%

Comparables Summary

Public Comparables	Median	Implied Price	Weight
FY21 EV/EBITDA	10.0	17.3	60%
FY22 EV/EBITDA	12.3	26.1	20%
FY22 P/E	22.2	20.5	20%
Blended Valuation			19.68
Current Share Price			16.60
Implied Return			19%

Source(s): Bloomberg, Company Filings

Sensitivity Analysis/Street Estimates

Valuation Range Supports Our Estimate

Sensitivity Analysis | WACC vs. Exit Multiple

		WACC				
		6.1%	6.6%	7.1%	7.6%	8.1%
Exit Multipe	7.0x	17.45	16.78	16.14	15.52	14.93
	8.0x	19.09	18.35	17.64	16.96	16.31
	9.0x	20.73	19.92	19.15	18.41	17.70
	10.0x	22.37	21.50	20.66	19.85	19.08
	11.0x	24.01	23.07	22.16	21.30	20.47

Sensitivity Analysis | WACC vs. TAGR

		WACC				
		6.1%	6.6%	7.1%	7.6%	8.1%
TAGR	1.6%	24.68	21.93	19.67	17.79	16.19
	1.8%	25.58	22.63	20.23	18.24	16.56
	2.0%	26.57	23.39	20.83	18.72	16.95
	2.2%	27.66	24.22	21.48	19.24	17.37
	2.4%	28.86	25.13	22.18	19.79	17.82