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Long: Spirit AeroSystems (SPR) - $30

Spirit AeroSystems is a tier-1 supplier to the A&D industry, meaning it is the last stop before reaching the prime contractor on a program and will deliver the product up to 80% complete. Its largest exposure is to the Boeing 737 MAX which accounts for 35% of revenue, down from +50% pre-crisis and on the way to a steady state level closer to 40%. Over the past few years SPR experienced two left-tail events in the MAX grounding and then COVID. Management is now not getting any credit for the significant diversification following the acquisition of Bombardier's assets in 2020 in addition to cost savings on the MAX that will both work to help SPR achieve stead-state margins sooner and grow its reasonable revenue/profit opportunity into the decade.

The stock is very compelling at current levels (IRR +20% over 3 years). When considering the 'price x quantity' relationship of the business, investments have been made on both sides of the equation (expanding scope of aftermarket work with specialty solutions "p" before international travel recovers "q"; signing on multi-year defense production agreements that ramp significantly over the next few years "q"; investments into lowering the company's cost basis for the 737 "p" as BA ratchets up production "q") that have yet to be reflected in results and are overshadowed by near-term headwinds.

A brief overview of the main drivers:

Commercial:

- 737: Still a huge component of SPR's revenue and margins. The company has made investments that brings the target margins of 16.5% achievable at production of 42/month (31 currently, target +50 previously). Boeing is facing intense competitive pressures that makes it very likely that they will strive for at least 50/month (achievable by 2025) to maintain market share.
    - The largest risk appears to be destocking the ~100 planes in inventory, preventing higher production rates even as BA rises. I think this view is mistaken, as the company remains cashflow+ at ~30/month, and delays should only push out targets, rather than lead to an equity raise, with working capital unwinding helping add to cash. Essentially, the market is far too pessimistic on the weight of inventory.
    - Timing is a concern given the maturities on the horizon but if SPR approaches them CF+ and growing, I think that the credit markets will not be so harsh and a refinance is very possible. But this is plan B; they should generate enough cash as production rises. The main hurdle comes in 2025.
    - Once supply chains normalize, the path to 50 will be faster than 2016-2018 levels, which many expect, since the tooling is all there.
- 787: This has become a money loser for the company due to issues in the construction. SPR will lose ~$1mn on every delivery until the contract is renegotiated late-decade.
    - The market is missing that the 787 will face impaired production rates which will stem the rate of cash burn while the 737 heats up due to BA's built-up inventory. In 2H22 specifically, all 787s will be CF+ since most costs were accounted for in 1H.

- Earnings upside can come from business jet work as orders are persisting much longer than many expected in addition to expanding Airbus content from the company's decent scope today via acquisitions and new contracts.

Aftermarket:

- Through the acquisition of Bombardier and Applied Aerodynamics, SPR found an initial MRO footprint that it has grown via new locations (China, Middle East, Central America) and greater repair scope. These investments are not being reflected while travel is below 2019 levels.
- The scope added to repairs has moved beyond initial specialty repairs and into more common/routine areas that will help attract more business and leverage the same fixed cost basis needed for what was previously offered.
- Margins will be in the 20-25% range based on some specialization in the types of repair and synergies with its OE manufacturing. These are higher than pure MRO companies but lower than a parts company like TDG since the focus is on repairs that are more incidental (like birds flying into the plane) and not entirely sole source, with a lot of the margin uplift coming from lower costs vs. peers due to OEM overlap.

Defense:

- Over the past few years, SPR has won work on a variety of marquee programs in the industry including the aircraft (B-21, CH-53K, P-8), missiles (GBSD, THAAD), and then call options in hypersonics, space, and programs awaiting award, like FLRAA. The company has work on ~25 development programs that each add to the long-term revenue potential if awarded.
- There have been issues relating to the supply chain reverberating throughout the industry. SPR sees $1bn in revenue by 2025 based on existing programs that have already been awarded and contracted. Any lost revenue in delays during this timeline to $1bn is better seen as deferred due to relatively solid total production commitments on most programs.
- Margins are being sandbagged to the development work (~sub-10%) and will expand over time as programs reach production (~12-14%).
- Longer term, there is much more opportunity for tier-1 suppliers to grab more work from the defense industry which does most of their work in-house or subcontracted to other defense companies. A foot in the door will go a long way for winning future work given the clearances and proof needed to justify more work.

Management:

- Between 2014-2019 the company bought back 25% of shares outstanding and came out of COVID without diluting shareholders.

- The acquisitions of Bombardier assets, Applied Aerodynamics, and FMI will be retrospectively viewed as very smart given the basis for the Aftermarket and Defense segments that the company is building on.
- After reaching IG debt and normalizing 737 production, the company will be on solid footing to resume buying back shares via generated cash and as a continued recap supported by higher terminal EBITDA.

Valuation:

- By 2025-2026 the company can achieve ~$8bn in commercial revenue (16.5% margin), $1bn in defense (13%), and $500mn for Aftermarket (22.5%) = $9.5bn revenue and $1.6bn segment profit (~16%).
- Less $500mn in SG&A + R&D = $1.05bn operating profit
- Interest of $150mn (~$1.5bn in EBITDA 2x levered at 5%) and a 25% tax rate = $680mn of Net Income = EPS of $6.50 (assuming flat share count).
- At 10x P/E = $65 stock and 27% IRR over 3 years and 19% over 4, depending on the time it takes for production to normalize.
- Supported by FCF margin of 8% (achieved 2018-2019), valued at 10% yield = $73 stock and still growing. This is a 25% IRR over 4 years and 20% over 5 (which may be realistic considering the delays prone to SPR's end markets).

Risks:

- Inflation weighs on steady-state margins. Most contracts are protected but labor costs are an example of uncompensated costs.
- Delays.
- Permanent MAX production impairment.
- It could be wrong to perceive SPR as having changed from a vessel to increase Boeing's direct operating leverage to a company with agency. They would have to match BA if they chose to remain at MAX production levels of 31 forever or wanted to go to 100.
- The path to normalized production levels includes significant challenges that causes the company to issue equity at these depressed levels.
- Defense rests heavily on classified programs which leaves shareholders in a position where they simply must take management at their word beyond identifying broad trends (like +40% space-related funding in the budget) rather than being able to verify growth outlooks.
- Aftermarket, while the best corner of A&D for sole-source/specialty products and solutions, can be commoditized on the MRO side of things and will rely on a lower cost basis, which can erode, compared to pricing power.