Leonardo (BIT:LDO) Recommendation

Leonardo (BIT:LDO) is an Italian aerospace & defense (A&D) manufacturer emphasizing production of helicopters.

Comparable Companies Analysis

We performed a comparable companies analysis comparing Leonardo to thirteen other aerospace & defense manufacturers. We found a median price-to-earnings (P/E) ratio of 15.2x and a mean P/E ratio of 16.0x. At its current share price of $6.50 and earnings per share (EPS) of $1.34, Leonardo is trading at a P/E ratio of approximately 4.87x. Using the median P/E ratio of 15.2x and this EPS produces an implied share price of $20.35, implying an upside of 213%.

Concerns

We do not expect a full 213% upside to be realized. There are a number of concerns that mitigate, but to not reduce to zero, the potential upside from taking a long position on Leonardo.

First, the majority (eleven out of thirteen) of the companies chosen have market capitalizations greater than Leonardo. Larger companies may trade at higher P/E multiples due to greater market confidence in their long-term sustainability, and as such we do not expect Leonardo to fully reach the median P/E multiple of its chosen peers. Further, P/E multiples of the two companies in the chosen set with market capitalizations smaller than Leonardo's were both not meaningful, as both companies turned a net loss in the LTM ending in the first quarter of 2020. This does suggest that Leonardo is outperforming its peers-in-size, a positive sign for our long position.

In the selection of comparable companies, we sought to emphasize helicopter manufacturers. There proved several barriers to this: of the major helicopter manufacturers, many were already accounted for in the survey of major A&D companies originally chosen. The remaining helicopter manufacturers were either privately held (e.g. Cicare), meaning insufficient data on them were publicly available or were segments of large manufacturing conglomerates (e.g., Textron, Mitsubishi, Fuji, and Kawasaki), whose inclusion would distort the chosen ratios due to their segments in other sectors outside A&D. As such, a broad survey of A&D manufacturers was chosen to suffice. We have insufficient data at this time to say whether this imprecision would skew our implied share price higher or lower, so it is not of particular concern.

The fact that Leonardo is based in Italy poses some risks due to the fact that Italy at one point was worse-affected by COVID-19 than many other nations. However, this trend has not held true: Italy's daily increase in both cases and deaths has significantly and consistently decreased since its peak. It is now faring orders of magnitude better than the United States—the home of many of the other A&D manufacturers chosen—and, as such, we expect many of Leonardo's peers to suffer harder than it from COVID-19 in the long term.

In our comparable companies analysis, we also compared companies' 2018 arms sales with data taken from the SIPRI database. Leonardo stands as the world's eighth largest government defense contractor, with significantly higher government contract revenue-to-enterprise value ratios than any of the major competitors examined in the comparable-companies table (110% compared to a high of 96% from BAE Systems, a UK-based defense manufacturer for which defense contracts form a much larger proportion of total revenue than for Leonardo). Examining the proportion of 2018 revenue deriving from defense contracts, Leonardo has a level of diversification around the industry standard (68% compared to a median of 72%), strategically combining the stability of government contracts with the growth opportunities that accompany commercial exposure. Despite its small size, its current standing demonstrates an ability to effectively differentiate itself and hold its own against larger players in the A&D industry. We are thus not concerned about it losing market share to competitors on the basis of its size. In the event that its size spurs an acquisition, this would have a positive increase on share price and increase the strength of our LONG position.

Discounted Cash Flow Analysis

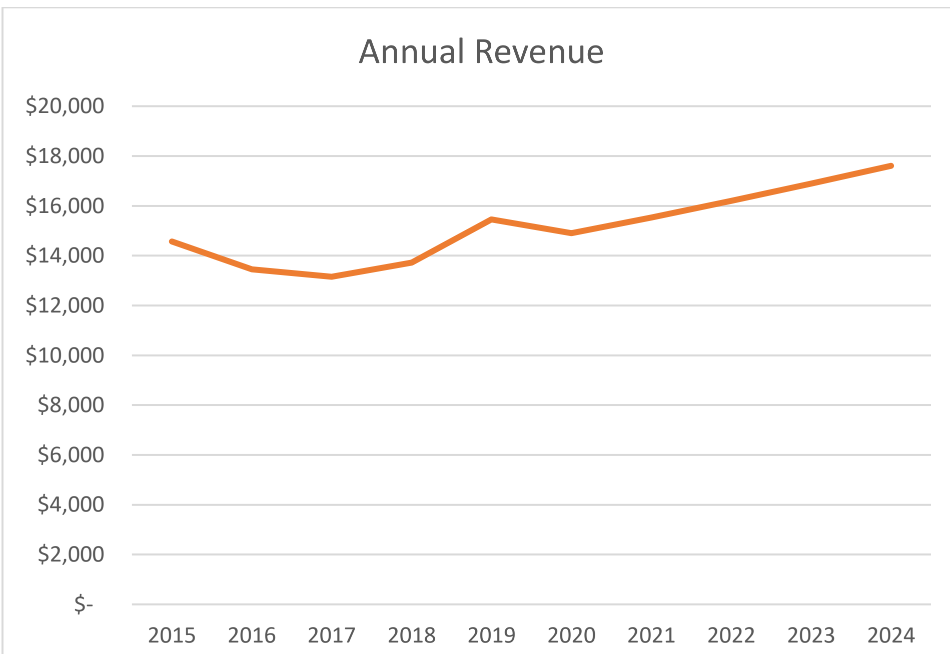
Cash Flow Projections

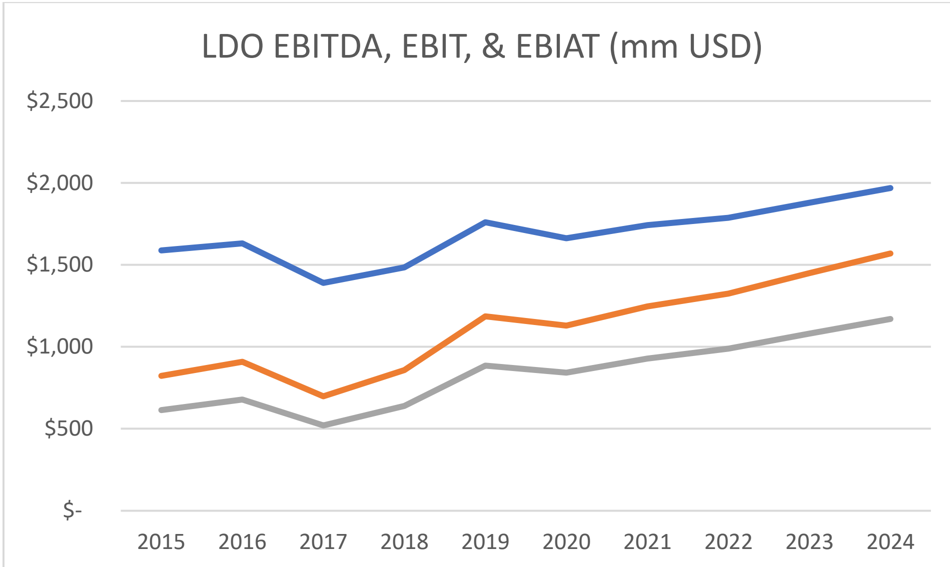
We projected unlevered free cash flow through 2024.

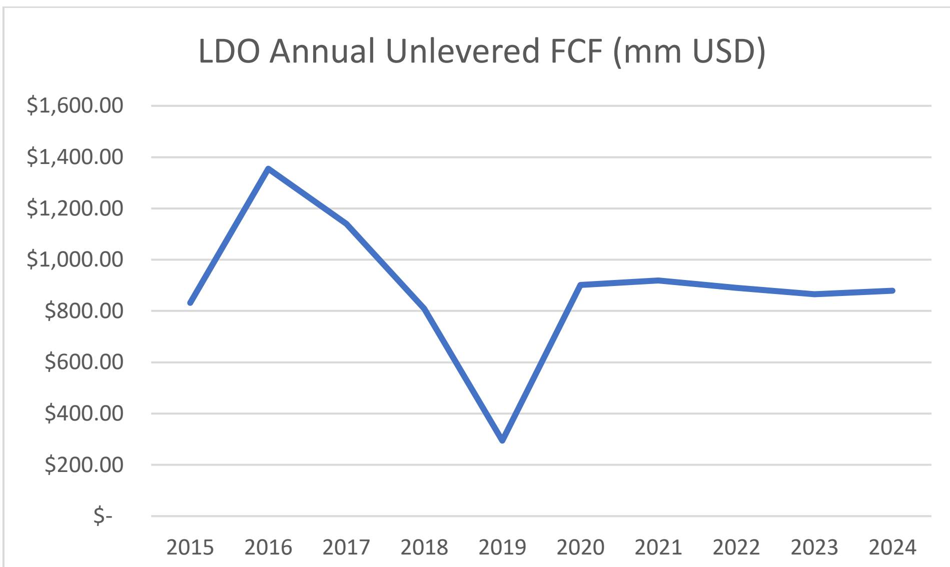
For the 2020 revenue projections, we used the compounded annual growth rate (CAGR) for 2015-19 multiplied by 2019 revenue, multiplied by a coefficient of 0.89 to represent economic hardship induced by the novel coronavirus. For 2021-2024, we multiplied the previous year's revenue by the CAGR since 2017 (the five-year low from 2015-19).

To project EBITDA, we multiplied each year's revenue by the average EBITDA margin for the trailing five years. To project (income statement) depreciation, we multiplied the previous year's depreciation by the CAGR since 2015. The tax rate used was the five-year average of 25.42%. Cash flow statement depreciation was calculated similarly using the CAGR since 2017 multiplied by the previous year's depreciation. Capital expenditures (CapEx) were projected using the CAGR since 2015 multiplied by the previous year's CapEx. Changes in working capital were calculated using the average of the trailing five year's COWC.

These projections result in the following:







Cost of Capital Assumptions

The risk-free rate was first calculated using the historical returns on 10-year treasury bonds (T-bonds). Among a one-year, one-month, and 180-day average, the third was the most conservative (the highest risk free rate), so this was used. Using the current risk-free rate on the Euro would result in very generous estimates (as it is currently negative), so this rate was used in the interest of conservatism. Since all of our calculations were in US dollars, this is legitimate.

The equity risk premium is taken from Damodaran's equity risk premium for Italy, assuming 5.23% risk premium for mature equity market, adjusted for county default spread and volatility (at 1.25 multiplier).

Unlevered beta is taken from Damodaran, an average of European aerospace & defense (from a sample of 49 companies), last updated 1/5/20. Cost of debt was estimated from the interest rate divided by the company's total debt.

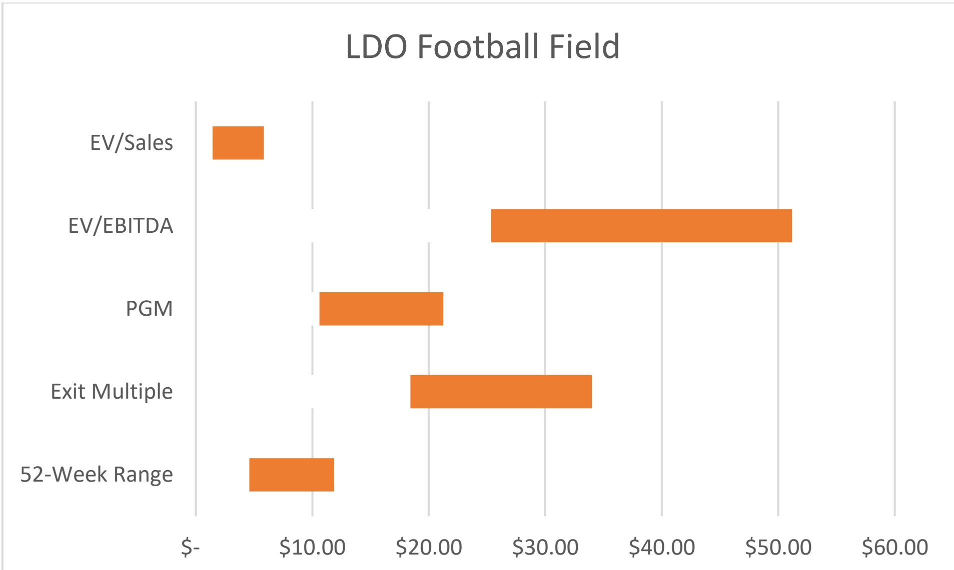
Terminal Value Assumptions

This recommendation does not constitute investment advice or an offer or solicitation to buy or sell any security or securities. All data were taken from Standard & Poor's NetAdvantage.

Current net debt and diluted shares outstanding were used.

For the perpetuity growth method, a terminal FCF growth rate of 1.5% was assumed. This implies a target share price of $13.20. Sensitivity tables produce a range of $10.61-$17.81.

For the exit multiple method, the median EV/EBITDA multiple of the comparable companies was used (10.3x). This implies a target share price of $24.17. The sensitivity tables produce a range of $18.42-$34.00.



At a current share price, this implies a strong LONG position on Leonardo S.p.A.

---*Wasim Rahaman*