Magellan Aerospace Corp

Calgary Portfolio Management Trust

Industrial
TSX: MAL
Buy Recommendation

March 1, 2018

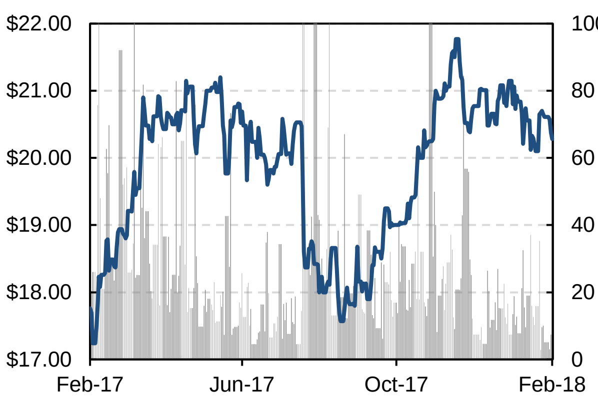
Darren Luoma, Portfolio Manager
Alim Suleman, Investment Analyst

Return on Investment	
Current Share Price	$20.05
Target Price	$25.65
Dividend Yield	1.30%
Holding Period Return	29%
Conviction Rating	2

Market Profile	
52-Week Range	$17.25 - $21.90
Shares Outstanding (mm)	58
Average 30-Day Vol (000s)	15
Market Capitalization (mm)	$1,167
Net Debt (mm)	$70
Enterprise Value (mm)	$1,237
Beta (5-Year Monthly)	0.44

Metrics	2018E	2019E	2020E
Revenue (mm)	$947	$973	$999
EBITDA (mm)	$163	$168	$172
EBITDA Margin	17.3%	17.3%	17.3%
EPS	$1.41	$1.46	$1.50
EV/EBITDA	7.6x	7.4x	7.2x
P/E	14.3x	13.8x	13.4x

Historical Trading Performance



Source: CPMT Estimates, Bloomberg

Business Description

Magellan Aerospace Corp (TSX: MAL) headquartered in Mississauga, Ontario, provides assemblies and systems solutions to defense and space agencies, as well as aircraft and engine manufacturers. The company is in the business of designing, engineering, and manufacturing products for the above-mentioned industries. MAL's major customers include Boeing (16% of revenue) and Airbus (22% of revenue). The Company's sales are divided into three regions; Canada (34%), the U.S. (34%), and Europe (32%).

Industry Overview

MAL's revenue is mainly derived from three industries: commercial aerospace, defense, and space. With regards to commercial aerospace, steady growth is expected for this sector over the next few years as the disposable income of North American's continues to grow, resulting in increased demand for travel, fueling the need for airlines to expand their fleets. Although North American's are expected to travel more, the growth in this space will truly be driven by the increasing demand for travel by aircraft in emerging markets. Airlines are expected to continue expanding their fleets to serve these under-flown emerging markets. Another industry driver over the next few years will be the replacement of older, less fuel-efficient aircrafts with newer, more efficient, models. Overall, the outlook for the commercial aircraft industry remains strong.

On the defense side of things, although U.S. military spending has been relatively underwhelming over the past five years, the Trump Administration has changed the situation. Lockheed Martin recently announced that they will be purchasing 440 aircrafts over the next three years in response to increasing demand. This bodes well for MAL, as MAL is a major supplier and assembler for Lockheed Martin, so the Company should be able to generate a significant amount of revenue over the next few years from Lockheed Martin.

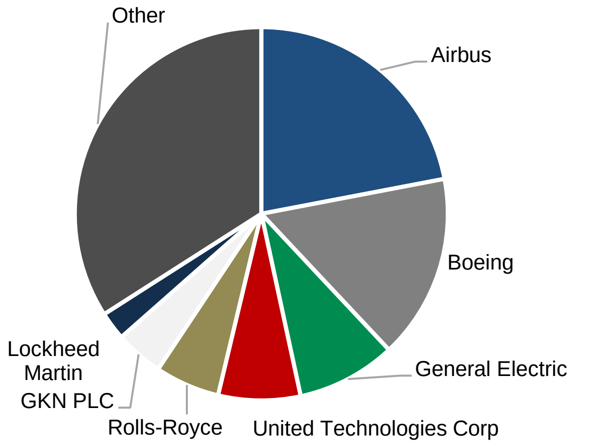
With regards to the Canadian space & vehicle manufacturing, the sector has been declining over the past five years and is expected to continue doing so for the near future. The Federal Government's budget is expected to increase at a rate of 1.4% per year over the next five years, with most of the increase expected to be going towards the healthcare sector, leaving funding for space & defense programs up in the air, especially considering the pressure to cut the deficit. On the commercial demand side of things, demand is expected to grow, albeit slowly, due to the worlds increased reliance on satellite technologies.

Although we do not expect the Canadian aerospace & defense sector to contribute significantly to the growth of MAL in the near future, we expect the growth in the U.S. defense & aerospace to more than make up for the lack of growth opportunities in Canada. Furthermore, the strong outlook in the commercial aircraft space both in North America and abroad leaves us feeling comfortable with where MAL operates, as we believe that the company will have opportunities to continue growing for the foreseeable future.

Valuation

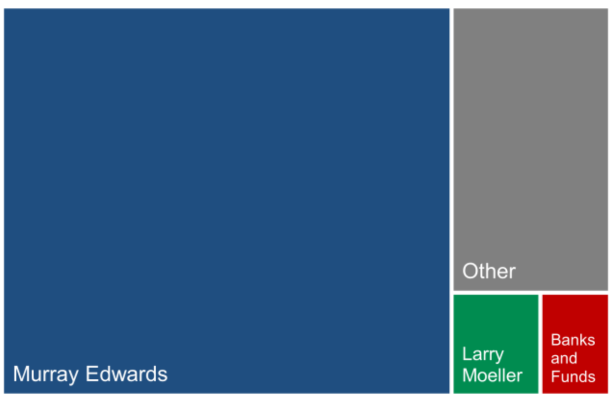
MAL was modeled using a 50/50 blend of a 10-year DCF Gordon Growth (2%) exit, a 10-year EV/EBITDA exit. The DCF was very conservative, with low growth rates used throughout the model; yet, the target price still represents a significant return on the Company.

Major Customers



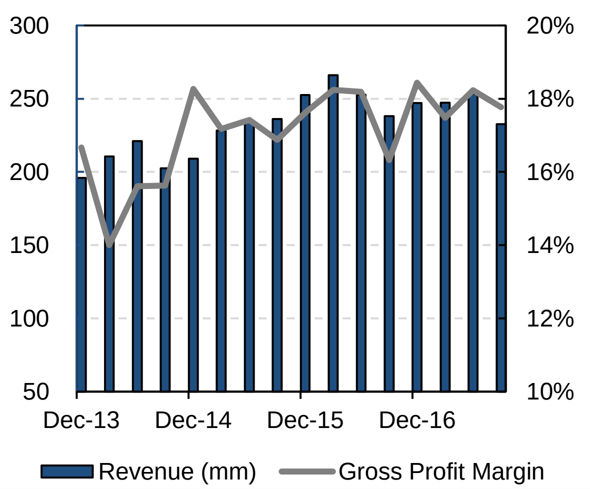
Source: CPMT Estimates, Bloomberg

Ownership Breakdown



Source: CPMT Estimates, Bloomberg

Revenue and Margin Growth



Source: CPMT Estimates, Bloomberg

In recent years, MAL has been increasing margins by reducing their operating costs. In fact, the Company has some of the best operating margins in the industry. This trend of increasing operating margins was factored into the model conservatively, with a last eight-quarter average operating margin forecasted forward in the model. With regards to a comparable company analysis, MAL currently, and historically has traded at a discount to its competitors. Although, given the best in class operating margins, growing free cash flow, and low debt of MAL, we expect this gap to minimize in the future. A very conservative discount rate was also used in the analysis, given that MAL operates in aerospace & defense, a low beta would have been appropriate in calculating a discount rate, but to compensate for the uncertainty in Canadian defense & aerospace going forward, an upwards beta adjustment was used. To conclude, the model yields a target price that represents a significant return to the Fund, even with conservative assumptions.

Ownership and Management

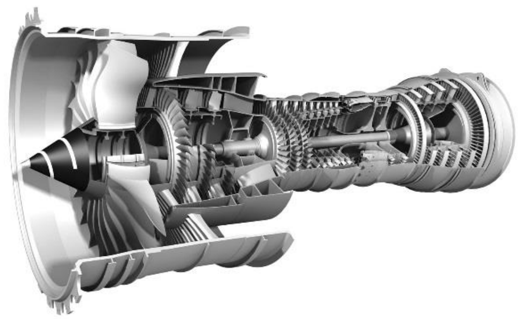
Ownership is very concentrated, with chairman of the board, Murray Edwards, owning 74% of the Company. With Mr. Edwards as chairman, it is no surprise that MAL is one of the best cost controllers in the space. Mr. Edwards has not sold off any off his position in recent years, although it would not be a surprise if he started to do so in the near future to lock in some of the gains he has made. The President & CEO, Phillip Underwood, joined MAL in 2003 when the Company expanded into Europe. Prior to joining, Mr. Underwood held senior aerospace positions in the U.S. and in Europe. He was promoted from Vice President, European Operations, to CEO in January of 2015. The CFO, Elena Milantoni, joined MAL in 2007 as Corporate Controller and Treasurer. Prior to joining, she held various financial management positions with a variety of publicly traded companies. One red flag with regards to the Company's corporate governance system is that there does not seem to be any requirement for management to hold shares, although compensation is directly tied to share performance through DSU's. As a result of this, President & CEO, Phillip Underwood does not hold any shares.

The board has nine members, five of which are classified as independent. Two members are approaching the age of 90, and will soon need to be replaced. Members of this board also sit on the boards of CNRL, Home Capital Group, and Imperial Metals Corp.

Risks

There are a few significant risks to consider when contemplating this investment. First of all, the sources of the Company's revenue are highly concentrated, particularly in Boeing and Airbus. If these companies elect to stop using MAL as a major supplier, MAL's revenue stream will decline significantly. Second, revenue in this industry is highly dependent on landing government contracts, which gives very little long term line of sight in terms of revenue projections. Finally, a last major risk for the company exists as aircraft manufacturers are struggling choosing between an increased production versus a willingness to fly older aircrafts for a longer period of time. A decrease in new aircraft production could negatively impact MAL's bottom line. After a thorough consideration of the risks the Company faces, we believe that although downside is significant, the possibility of these risks causing a dramatic decrease in the Company's revenues is small enough to still view the Company as a viable investment.

Aeroengine



Source: technicut.ltd.uk

Investment Thesis

MAL was found using a screen that focused on free cash flow growth over the past five years, as well as a low DEBT/EBITDA ratio, combined with looking at ROIC over the past five years. Given the current debt structure of MAL, we believe that the company has the ability to make significant capital investments over the coming years if the opportunity for investment arises. Given that the company has made strong work of their capital in previous years, we believe that if and when the capital is deployed, strong decisions will be made. To sum up, provided MAL continues to land contracts, there will be more than enough financial flexibility to take on the debt necessary to make a substantial acquisition.

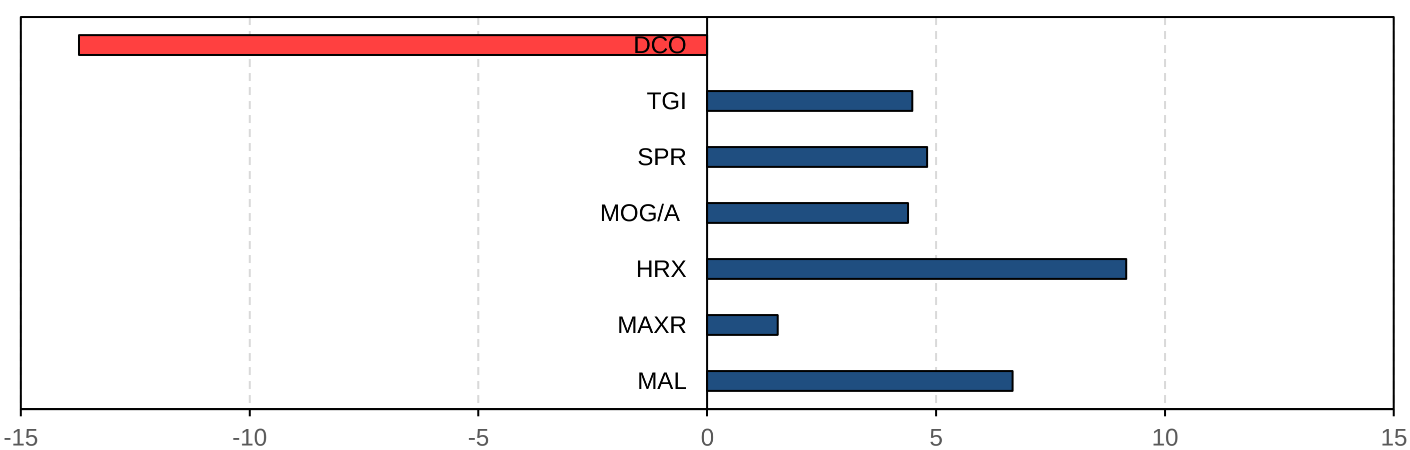
Along with the low debt and growing free cash flow, the Company has a strong management team and corporate governance structure, which leads us into competitive advantage. In an industry such as this, it is extremely difficult for companies to establish a sustainable competitive advantage, but we view MAL as having exceptional technical expertise, as seen by Airbus's faith in the Company, selecting them to assemble and develop complex engines. Also, the ability of the Company to control costs can be seen as a competitive advantage, leading to best in class margins. With regards to the CPMT investment mandate, MAL clearly checks all of the boxes.

Comps Analysis

Name	Price	Mkt Cap (CAD)	P/E	EV/ EBITDA	Sales Growth (%)	Gross Margin (%)	Operating Margin (%)	ROA (%)	ROE (%)	Debt/ EBITDA	LTD/ Total Assets	ROIC (%)
Average	47.51	2,949.56	16.63	10.59	-1.42	20.26	6.71	3.21	4.89	-0.96	25.58	4.70
Median	28.27	1,363.50	14.45	9.97	2.80	19.29	8.15	2.79	6.21	2.53	23.46	4.37
Magellan Aerospace Corp	20.10	1,170.00	12.82	7.06	5.50	17.82	12.09	10.44	16.59	0.41	5.86	12.49
Maxar Technologies Ltd	64.71	3,647.25	11.00	9.22	4.66	23.09	1.98	1.94	6.21	18.76	44.21	3.98
Heroux-Devtek Inc	14.60	528.13	20.62	9.97	-0.07	16.72	8.75	2.79	4.73	2.53	20.97	3.65
Moog Inc	85.05	3,040.15	20.92	10.42	3.55	29.29	9.24	3.68	10.14	2.98	30.95	7.11
Spirit AeroSystems Holdings Inc	92.39	10,577.66	14.45	9.73	2.80	11.75	8.15	6.65	19.02	1.47	21.26	11.88
Triumph Group Inc	27.45	1,363.50	11.08	16.40	-9.09	23.86	1.61	-5.47	-28.61	-37.40	23.46	-10.54
Ducommun Inc	28.27	320.25	25.51	11.33	-17.32	19.29	5.19	2.41	6.16	4.51	32.38	4.37

Source: CPMT Estimates, Bloomberg

Free Cash Flow Yield



Source: CPMT Estimates, Bloomberg