Valuation Discussion: Magellan Aerospace (TSX.MAL)

Initial Screening

Magellan Aerospace has a market capitalization of CAD1.2 billion, relatively low P/E of 11.87x and a reasonable P/B of 1.7x. The relatively small market cap may reflect limited institutional ownership and research coverage, and thus believe that Magellan Aerospace may be undervalued.

Business Risk Assessment

Industry Risk: Aerospace and Defense (A&D)

The A&D industry is of moderate risk due to cyclicality, intense competition, eased by contract based revenue and relatively predictable cashflows from major companies with low credit risk (clients tend to be large with strong balance sheets). The company is a diversified supplier of components to the commercial aerospace (73% of revenue) and defense industries (27% of revenue). It engineers and manufactures aero-engine and aerostructure components for the aerospace, defense and space markets while also offering customized complimentary products to other customers. We assess the A&D sector to be a *Medium-High Risk Industry***.**

Financials: Revenue has grown at a 10-year CAGR of 5%, and MAL has achieved gross margin of 18%, and operating margin of 11.9% as at 3Q17. Operating Margins are in-line with industry average of 12%, but this was not always the case. The company has expanded its margins over the past 10-years. All margins have expanded by an average of +5%. Magellan's revenues and profitability have grown steadily, indicating that it has done a good job of maintaining and expanding its competitive position in the marketplace. Its long-term contracts with clients also indicate that there is continued visibility of cash flows, which assists with management planning.
BR Conclusion: Based on the above, *MAL's Business Risk is **Medium**.* Based on a Moderate business risk assessment, the implied *Optimal Capital Structure* for this business is *between a 30% and 49%* lease-adjusted debt to book capitalization.

Financial Risk Assessment *Target Capital Structure:* Both a 5-year average and a most-recent-period assessment of MAL's capital structure implies a *Target Capital Structure of 20.2%*. (average FY16 and LTM3Q17; Please see Exhibit 1)
FR Conclusion: Target Capital Structure is *below the Optimal range*; implied *Financial Risk is **Low.***

Weighted Average Cost of Capital

Risk Free Rate: 2.31%; 10-year Government of Canada yield (S&P Capital IQ)
AA Rated Spread: 52bps per average Canadian yields (Bank of Canada); AA rating affirmed against S&P average ratios, refer to Ratings Scorecard in Exhibit 2.
Kd: ***2.83%*** based on Rf + Credit Spread above. ***ERP:*** ***4%*** for a Medium Business Risk / Low Financial Risk business. ***Ks:*** ***6.83%*** derived from Kd+ERP. **WACC:** **5.89%** (Exhibit 3) WACC=Kd*(1-T%)*B/V + Ks*S/V (target cap structure weights used for B/V & S/V)
First Pass ROIC: **11.66%** as derived from EBIT*(1-T%) / Operating Assets, with Operating Assets calculated by both of:
1) Current Assets + ECMS + C. Liabilities (net of ST Debt) + Net PP&E + Def. Tax Assets + Intangibles; and
2) Total Assets – ECMS – C. Liabilities (net of ST Debt)
First-Pass ROIC of 11.66% exceeds WACC of 5.89%, so we expect that EPV will exceed NAV. Please see Exhibit 5.

Net Asset Value: $13.91 implied price per share. Please see Exhibit 4 for our assumptions and calculation.
Replacement value of MALs assets, based on a Net Asset Value assessment, is $1,113.1MM. A/R are grossed-up by dividing total A/R by 95% to adjust for an estimated 0.5% Allowance for Doubtful Accounts (as per notes in annual report).
Product Portfolio Value is $86.3 MM. Since MAL capitalizes R&D already, we added back amortized amounts to get original cost.
Customer Relations Value is $70.0MM, derived using SG&A/2 as % Sales over 10 years, multiplied by 2.5 representative of the critical nature of the products MAL sells and the concentration of the customers. We lowered it to 2.5 because of competition. Search costs and switching costs for this business would be very high, while products are crucial to customers. Please see Exhibit 8.
Market Value of Debt is $70.98 MM calculated as the ratio of Avg. Coupon (Interest/Avg. Debt) divided by K * LTD, less CP LTD + RC.

Earnings Power Value: $20.31 implied price per share. Please see Exhibit 6 and 9.
Normalized earnings based on a 5-year average EBIT/Sales were $12.4MM, which is more indicative of normalized EBIT than 10 yr. due to business developments. We also adjusted EBIT by several items to create a normalized after-tax EBIT, for which present value was taken in perpetuity (discounted at WACC).
Second-Pass ROIC: **7.02%** is derived as NOPLAT divided by operating assets (both calculations, in line with First-Pass ROIC above). This value is both lower than First-Pass ROIC, and still higher than calculated WACC. This further reinforces that MAL has franchise value, and potential moat. Please see Exhibit 5.

Franchise Value: Potential $1.18 per share; Sustainability-Rate-Adjusted $0.89 per share
MAL fulfills all three drivers of Franchise Value: 1) *Government: G*overnment impact on MAL's franchise value is minimal, but it exists through high standards and lead-in times in order to win Govt. Defense Contracts; 2) *Management*: We view MAL's management as solid capital allocators, and strong operators of the business. For example, there is a low Goodwill number despite many acquisitions as expansion of margins; 3) *Barriers to Entry*: We believe MAL's scale, and product mix create high search and switching costs for customers due to nature of products. MAL has long term contracts that also support high search and switching costs. We have ascribed a Franchise Sustainability rate of 75% to the potential Franchise Value of $1.18 which results in an adjusted value of $0.89 per share.
Third-Pass ROIC: 6.47% This figure is lower than Second-Pass ROIC because revenue growth between FY16 and LTM 3Q17 was negative (i.e. revenues fell), which would have resulted in negative growth-related R&D and marketing add-backs; these adjustments have thus been omitted. Further, normalized EBIT includes lower-margin years extending back to 2013, resulting in lower normalized EBIT than actual EBIT as of 3Q17 for the purposes of this calculation. Third Pass ROIC is still greater than WACC. Our next step is to quantify how much value the growth adds to our intrinsic value.
Growth Value: We calculated our sustainable growth rate to be 1.4%, which is just above the risk-free rate and rate of inflation. Our Value Growth Multiplier is 1.027, which is lower than 1.5, so we multiply our Base EPV by our VGM of 1.027 to get $20.86. Because our VGM is lower than 1.5, we need to take our EPV plus growth value and then take a 33% margin of safety to get an entry price of $13.91.

Decision: Intrinsic Value is $20.86, our ***Entry Price of $13.91***, this stock is a **DO NOT BUY (add to watchlist)**. Please see Exhibit 7.