Aerospace Flies Above the Market



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ALEX BERNSTEIN: Hello, I'm Alex Bernstein and you're listening to The Alger Podcast, Investing in Growth and Change. Despite the previous year's market churning, one sector that seems to have remained mostly resilient is industrials, and especially the aerospace industry. Here to discuss what may have led to that resiliency is Alger Senior Analyst and Head of our Industrials Sector Andrew Gustin. Andrew thanks so much for joining me this afternoon.

ANDREW GUSTIN: Sure, Alex, and thanks so much for having me on the podcast. It's always great to catch up with you.

ALEX: Andrew, just to get started, can you give us a view of the current economy from the industrials sector?

ANDREW: **We** think industrials have really outperformed over the past year. I would say, industrials have not had the same degree of valuation compression that you've seen in tech and some of the other growthier sectors. There have been a couple of really quite strong subsectors within industrials. The two best performing have been defense and energy. Defense has really been driven by the tragic geopolitical situation since the Ukraine invasion and energy has been driven by much higher oil prices. I would say, broader industrials, they have weakened, but not to the same degree as consumer and tech where you've seen just a much sharper sell-off.

ALEX: And what have been some of the biggest challenges?

ANDREW: We think it's been an incredibly challenging time to be a manufacturing company. We went through COVID. A lot of companies really quickly had to cut their costs, lay people off, and all of a sudden, the markets and demand kind of came roaring back. We've had these prolonged supply chain challenges and we've had difficulties in hiring people back. It's been a continual challenge. Labor certainly has been very difficult.

Supply chain. You're trying to manufacture product that has lots of different components and in any given week you get an unexpected call from a supplier saying they can't get you what you need, and then you have to call your customer and you're going to be late with your product. We've been hearing a lot about industrial companies kind of playing the whack-a-mole game where they never know what the next component might be that they can't get a hold of. So, it's been a really challenging time and I think some of the better run companies have differentiated themselves and weathered this period better than others.

ALEX: Andrew, I wanted to ask about inflation and the rising interest rates, and whether or not your companies had already priced that in.

ANDREW: Inflation, we think, has been another enormous challenge for all these companies and many of them are saying they're seeing inflation that they haven't seen in many years. The companies that have really good pricing power that can actually pass through those cost increases, those guys are basically, they're able to offset the cost headwinds, but there are many others that haven't and so you've seen margin headwinds at a lot of companies.

I would say that you're starting to hear that the peak inflation has maybe passed us and that the boil is coming off a little bit. The supply chain bottlenecks are not as bad as they were several months ago. There are components that are now more available than they were. It's certainly far from normal, but it seems the pressure there is attenuating a little bit.

ALEX: So, let's talk a bit about the aerospace industry. Because from where you sit, that sector seems to have actually performed well over the past year. Is that right?

ANDREW: Yes, well, COVID was an unprecedented downturn that hit the commercial aerospace industry. Never before in modern air travel had the entire globe basically shut down all travel. So, it was a tremendous shock to the system, and it was hugely damaging to a number of companies' financial performance and stock performance in the short term.

ANDREW continued: WellFast forward to where we are now, U.S. air travel is within ten percent of fully recovered from pre-COVID levels. Globally, we're still about 25 percent away from pre-COVID levels and so you have different regions that have recovered faster than others. And Asia still offers the most recovery going forward, in particular China, because of the extended lockdowns and the zero COVID policies they've had over there.

China flight activity is still about 75 percent below pre-COVID levels and China, before the pandemic hit, was 20 percent of overall global air travel. So, the recovery in China and the recovery in international travel, particularly in Asia, we see that kind of as the next leg of the recovery from COVID. We're very much on the way to recovery, but many of our companies are still well below the normal levels of revenue that they had pre-COVID.

ALEX: Where do you think we stand with aerospace subsectors, like commercial aviation and defense?

ANDREW: I would say commercial aviation, commercial air travel, traditional airline travel, that got hit the hardest. Interestingly, business jet utilization initially got hit, but actually recovered quite quickly and has actually recovered to above pre-COVID levels quite quickly. And I would say defense really did not see that much of an impact. The defense industry has been dealing with supply chain challenges like the rest of the industry, but they didn't really have the same demand shock, and now in defense, we think you're seeing really a strengthening of demand and public support for military spending in the U.S. and among our allies in connection with what's going on in Ukraine. So, it really has been quite dispiriting between those end markets. Commercial aerospace is the area that has still the most recovery to go.

ALEX: Tell me about the activity you've seen in replacement parts.

ANDREW: So, it's interesting, we have had a long interest and appreciation for the commercial aerospace aftermarket, the replacement parts business within the aerospace industry. That business is directly tied to commercial air travel, just the number of flights flown. You consume parts as planes get used. So we believe that has recovered, but it has still got a pretty good amount of recovery to do. The way that the industry is set up with FAA oversight, there are tremendous barriers to entry, and it has allowed some of our favorite business models to be created.

So, on any given aircraft, every single part on the airplane is basically specified for that aircraft. And the FAA has approved a specific part. And in many cases, there could be only one supplier of that part. So, depending on who owns the IP, the engineering drawings, if you own the IP and you're the sole approved supplier of that part, you have this tremendous incumbency and pricing power. And if you're the only provider of that part, you certainly have the ability to raise prices to pass through inflation. We have a couple of companies that that is a great niche that they've carved out and they have been able to generate tremendous amounts of cash and replicate that in different parts of the airplane.

ALEX: And can you talk about some of your specific aerospace holdings?

ANDREW: We have two main holdings. One is a company who specializes in proprietary sole sourced parts. It's a company where 90 percent of their revenue comes from proprietary parts and 80 percent of their revenue comes from parts where they're the sole source manufacturer. So, we think they have a truly unique ability to command price increases. Even in more normal times, that has enabled them to generate very high levels of profitability and they have continued to do that through the COVID pandemic. And there's still quite a bit of recovery left.

The second holding is the leading provider of alternative approved parts. So, there is an FAA process to become an approved alternative parts supplier, an alternative to the original manufacturer, but it is a very stringent and robust approval process in itself. So, we own the largest approved alternative parts provider, and they actually are able to price their parts 30 to 50 percent below the OEM's price. They do not have to compete to get the products initially spec'd into the aircraft. So, in the OEM market it's a little bit like the razorblade model. You don't make that much money on the original part, but you make tremendous margins on the replacement parts, and the aircraft can have useful lives of 30 and 40 years so there's lots of replacement parts, and you make great money for many years to come.

But as an alternative parts supplier, what this company does is actually reverse engineer an OEM part and makes it an exact copy of that part that meets all kinds of material quality and safety standards and gets approval from the FAA to be an alternative parts supplier, and prices it at about a 30 percent discount to the OEM part. So, in an environment where the airlines have been under a lot of financial stress and have been trying to reduce their costs, there has been a real appetite to find alternative parts suppliers and to get as much as possible from these alternatives. So, we think it's been a bit of a boon for this second company as well.

ALEX: Andrew, we're always talking about innovation at Alger. What kind of innovation are you seeing in aerospace?

ANDREW: I would say compared to a lot of other industries aerospace moves relatively slowly. It can take ten years to develop a new commercial aircraft. So, relative to maybe a consumer market where this is some app that comes out and all of a sudden completely changes and disrupts the marketplace, it's much more slow moving. And in fact, that has been a real source of strength for some of these incumbent providers who have really low risk of disruption.

Longer term, the most interesting areas of innovation going on in aerospace, as in many other industrial markets, revolve around carbon reduction, decarbonization. And like every other industry, the aerospace industry is looking at its emissions and thinking about how it's going to help the world decarbonize over the next few decades. So sustainable aviation fuel, electric propulsion, those are two areas where there's a lot of work and interesting innovation going on, but it's early stages. It's a multi-decade kind of process, I would say.

ALEX: Outside of aerospace, what else is exciting you currently in industrials?

ANDREW: We are getting more excited about early cycle industrials. Sectors like transports or even home related stocks that have been under a huge amount of pressure in 2022. We think some of these are already pricing in at a pretty substantial downturn, and we think that the stocks will start recovering ahead of their underlying industries.

Longer term, again, we're really spending a lot of time on decarbonization. Every single industry is working on decarbonizing over the next few decades and there's a tremendous amount of government support behind that. We think that is creating a lot of opportunities for growth, but it's also an area where we've seen a huge amount of speculation and euphoria in the last few years. So, at Alger we're staying very disciplined and selective in how we want to play that.

Within decarbonization, we have some of the more promising electric vehicle companies. We are involved in the leading solar inverter company and also one of the largest miners of lithium. So, we've got a lot of different angles that we're playing decarbonization, but as I've said, we've really worked hard to be disciplined around valuation because we've seen a lot of euphoria at different times in the last few years.

ALEX: Andrew, any final thoughts?

ANDREW: Well, I would say, At Alger, on the industrials team we focus on identifying high quality companies that have durable, competitive advantages and can be on for multiyear periods. I would say that we think industrials can be a relative bastion of stability where we can own companies for a long period of time and they can compound cashflow. We just don't see the same level of disruption and euphoria turning to despair that you see in some other markets. And I think that it has served us well to focus on high quality businesses and we're going to keep doing what we're doing.

ALEX: Andrew, thanks so much for joining me this afternoon.

ANDREW: Thanks, Alex. Great talking to you.

ALEX: And thank you for listening. For more of our latest insights, please visit www.alger.com.

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