

Industrial Growth in Unusual Places

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As we look at aerospace and defense, we see this market undergoing real change as the better companies bring new technologies to this industry. According to Weatherbie Capital, investors interested in innovation might look to the Industrials sector for unconventional growth opportunities. In our latest podcast, Weatherbie Director of Research Josh Bennett discusses the impact new technology and government spending are having on aerospace and defense.

ALEX BERNSTEIN: Hello. I'm Alex Bernstein and you're listening to the Alger Podcast: Investing in Growth and Change. Weatherbie Capital, a subsidiary of Alger, has been in the news recently for their style of investing which focuses on searching for dominant, sustainable growth in unusual and often mundane places. One sector that Weatherbie believes investors seeking innovation have overlooked is Industrials – and aerospace and defense companies in particular. Here with me to elaborate on that idea is Josh Bennett, Senior Managing Director and Director of Research at Weatherbie Capital. Josh, thanks so much for joining me this afternoon.

JOSH BENNETT: Thanks, Alex.

ALEX: You've mentioned that you're particularly interested in the Industrial space right now. Can you tell us why you're so focused on this sector?

JOSH: Sure. At Weatherbie, we think the best opportunity to add real value as we're investing our client assets is to focus on areas where we're seeing dynamic change. And we feel like when you look at the industrial sector, in many portions of that sector, it's been pretty stagnant. Technology, and therefore change, has been later in coming to that industry. That said, when we think about a group outside of traditional healthcare and technology - though we do that as well - if we can take our research skills and apply it to an industry like the industrial sector, that we can really get

a truly differentiated perspective on the companies we're looking at.

ALEX: You mentioned that, within Industrials, you're particularly looking at aerospace and defense companies?

JOSH: As we look at aerospace and defense, we see that market as undergoing real change right now. So, we're invested in a company in the commercial aerospace side, half of the business is OEM or original equipment manufacturing; they manufacture equipment for aircraft. What's truly unique about this business however is they are the dominant player in producing what are called PMA parts. So, PMA is a kind of government standard that stands for parts manufacture approval. This company takes OEM parts from major suppliers that you would know the names of. They shepherd them through the stringent FAA approval process and then they offer those parts at a 30 to 50% discount to the airlines. What does that do? It essentially lowers the cost of the airline and yet they're equivalent quality or sometimes even better quality.

ALEX: I assume the testing for quality is paramount?

JOSH: Yes. The FAA tests these parts to the point of destruction; to the point of failure. And as I mentioned, these parts need to be equivalent or better. Quite often the parts that this company is producing are actually better than the OEM standard. And these can be anything from critical engine parts of the aircraft, but it could also be something as simple as a tray table that folds down in front of you. Believe it or not that needs to go through the FAA approval process in the same way that an engine fan blade would need to go through. So, it's an important pipeline that you have to get through to get approved.

ALEX: So, for a company like this, what's your threshold moment when you say, "we've got to get this into the portfolio"?

JOSH: It probably came down to the visit at the headquarters. When I had the opportunity to actually tour one of their production facilities and meet with the operating has become the leading player in that. managers and understand in more detail what the process is of taking apart, doing a laser scan for example, understanding the kind of dimensions of the products, the real engineering of the metallurgy behind the product. These products were made to not be easily replicated by the OEMs. So it's not easy to do what they do. To get it through FAA approval is incredibly complex to manage. And this company has become the leading player in that.

ALEX: And the parts this company is making are in wide use?

JOSH: Oh, yes, yes. Nearly every major airline is now flying aircraft with their parts on them. And you wouldn't know the difference. I've flown on those aircraft and you have too.

ALEX: You also mentioned defense investing. Can you talk a little about that?

JOSH: Sure. On the defense side, research and development spending and investment spending has been under pressure for quite some time. And over the last two or three years, for the first time we've seen an inflection point and we're seeing defense spending free up. And what that means is you have more funds turning from appropriation into actual spend and the companies that we invest in on the growth side are beneficiaries of that increased spend.

ALEX: Can you give us an example?

JOSH: We're invested in a company that is leading the way in what are called tactical, unmanned, aerial vehicles, which are also called UAVs for short. What's unique is that these tactical UAVs are designed to fly in contested airspace. So, most so-called drones, up until this point, either fly way above the contested airspace, or they would be limited range units that are primarily used for surveillance, near the ground. What this means is incredible savings for the government. An F-35 Lightning, one of the top fighter aircraft that are out there, costs anywhere between \$95 and \$125 million roughly to produce. These tactical UAVs, which can accomplish many of the same missions that the F-35 Lightning can, can be produced for less than five million

per piece, and therefore keeping the highly trained and expensive pilot safely where they need to be. So, it's an incredibly effective way to use technology and doing that at a fraction of the cost.

ALEX: Do you think this is following a particular trend in government spending, right now?

JOSH: Yes. Absolutely. Trends in defense spending tend to follow over long periods of time the perceived threat level. The reality is, whether it's Republican or Democrat in the Presidency or in the House and Senate, today the perceived threat level is higher than it has been in quite some time. And what's maybe even more important there is it's the perception of what's called "near peer threats." That kind of raises the volume on the need for defense spending. Right now is a good time to be not just investing for the protection of citizens, but also to be thinking ahead for what could come next.

ALEX: And how did you find this company?

JOSH: When I met this company, frankly it was a company that I hadn't planned on meeting when I first showed up. But I knew that they were in the aerospace and defense sector, and I knew they had something to do with UAVs. As I questioned management and really dug into their business, I left saying this might actually be an interesting investment opportunity, but it's going to require more work. So then I dove into the work of understanding the current UAV landscape, the current budget backdrop for UAVs, the trends in overall defense budget, and then this company's competitive position within the defense space. And then as I thought more about this business and modeled it out, it seemed like there was potential and opportunity here that Wall Street was not fully understanding and not fully grasping.

ALEX: In a recent interview for Investment News, you made a comment that I thought was very compelling. You said that, at Weatherbie, you don't simply approach companies as investors, but as actual owners.

JOSH: Mm-hmm.

ALEX: Can you talk about that?

JOSH: Yes, I wouldn't say that I coined that phrase, but the way we think about it at Weatherbie, is we're not putting all this hard work into searching for these dynamic companies simply to get in and out of trades on behalf of our clients. We don't think about trading.

We're going very deep in our research. And we're working incredibly hard to understand the underlying drivers of growth and profitability for each and every one of those businesses in the Weatherbie 50. So, we don't get sidetracked by what happened last month, or what's going to happen next month or even next quarter. We pay attention to that if it's relevant to our thesis. But we want to think like owners. We're looking out three to five years instead of three to five months. And we're trying to understand, "Is this a good business? Is this growth really sustainable? And what would we pay for this business if we were going to go out and buy the whole thing?" That's a very different mentality than if you're going in trying to say, "can I make a quick buck on this thing because the quarter is likely to surpass expectations?" It's just a very different mentality. We are truly picking apart the business and trying to put on an owner's hat.

When you have the opportunity to get to the company headquarters or to a local site and meet the operating managers, as I did, of an aerospace company or a defense facility, that's when you really get to see the people who are doing the hard work, and that's where you begin to understand more of an ownership or an owner's mentality toward a business.

ALEX: Josh, thanks so much for speaking with us today.

JOSH: Thanks Alex. It's been great talking to you. Thank you.

ALEX: And thank you for listening. For more information on Weatherbie and the [Weatherbie Specialized Growth Strategy](#), please visit www.alger.com.

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