Thoughts From the Desk

May 29, 2024

Hello from the Desk,

*** Golf clap for Heroux-Devtek (HRX-CN) on another outstanding quarter.

In keeping with our theme of trusting your management teams, there is nothing like watching the materialization of something discussed months before on a factory floor at a time when things look bleakest. In this case, HRX's production volumes and factories throughput improvements.

Heroux Devtek is a position the firm has held for several years in the Aventine Canadian Equity Fund ("ACE Fund"). Exiting COVID, it has had arguably one of the best set-ups in terms of levers for capital appreciation: Value, Secular Trends, Performance Improvement, and Investment Narrative (/Momentum). The only thing missing was execution.

First, the stock price was cheap. This was understandable, post-COVID, as flight activity during a global lockdown did not bode well for customers' asset utilization or large CAPEX programs. However, looking beyond this period at the secular trends underpinning aerospace coming out of COVID, we expected a high probability of a favorable multiple mean reversion (as our base case) and a positive re-rating over historical levels as expected outperformance trends matured (as our bull case).

Second, the industry looked to have robust multi-year secular sector trends that would support performance over the medium-long term. As the pandemic progressed and faded, we noted two foundational trends underpinning the aerospace industry. First, an aging total addressable market. As fleets continued to depreciate, the runway (pun intended) for fleet rebuilding and modernization expanded far beyond current production volumes. Second, we noted the high asset utilization of the aging installed equipment base, which would benefit replacement parts and Maintenance and Repair ('MRO') and serve as a bridge until new equipment purchases recovered alongside customers' improving profitability. In our mind, fleet modernization is a critical process for customers, made more important by the higher average age, recent utilization trends, and lower industry supply volumes, which would ensure that demand for new equipment volume would eventually materialize.

Third, margin recovery. Here, we noted that favorable supply-demand dynamics would likely provide suppliers with improved pricing power, and the eventual rebalancing of production would lead to a long period of robust volumes. As such, we expected improved top-line and operating leverage to improve margins over time. NOW, when I said earlier that execution was the problem, it is important to realize that executing on margin improvement is much more complicated on the factory floor than in a financial model on the Desk. Over the holding period, HRX experienced material pressure on volumes and costs from disruptions in supply chains and labor. Hence, why we were on a factory floor talking to Management and their incredible team. While the discussion we had extends beyond the length of a blog post, re-reading it now, Management called their shot: labor availability eventually normalized; investments in equipment and productivity efficiencies came to fruition; and supply chain pressures eased (aided by in-house supply chain management techniques including an expanded supplier base and increased on-hand inventory levels to provide short term buffers). Thus, short-term issues, when addressed by the right management team, will eventually be solved, and when they do, the investments and initiatives made in prior periods will create exponential improvement moving forward, benefitting investors.

Fourth, investment narrative/momentum. Whenever a well-followed name breaks through a challenging period, there comes the point where the street becomes more comfortable with the run-rate recovery narrative. Eventually, larger investor inflows follow. At such point, existing investors benefit from higher analyst target prices, premium multiple justifications, and enhanced stock price support (bigger position sizing boosts the bid to acquire the amount of stock required (especially in lower liquidity names)).

On balance, there are multiple blog posts worth of talking points about why we like HRX, be it their mix of proprietary products, their diversification in European markets, the quality (and favorable timing) of their program list, the quality of Management, the attractive industry dynamics and positioning of the Company, etc. However, the lesson is that when a company checks so many financial lever boxes, and you trust management, when times look tough, that is the time to roll up your sleeves to generate alpha.

Best from the Desk,
James, Jim, David, Shannon, and Nicho