

December 2, 2016

Dear clients and colleagues,

Post US election, aerospace and defense stocks rallied on the hope that the new US administration would unleash big infrastructure investments and increase its defense budget. Many commercial aerospace stocks also benefited from that positive sentiment with a 7% price appreciation on average.

The commercial aerospace industry is experiencing slower growth in 2016. After a period of strong orders, over the past two years the book-to-bill ratios at Boeing and Airbus have been reduced from 2.5 to 1.2. On the positive side, manufacturers have accumulated an order backlog of 7 to 8 years which gives some reassurance that production rates will intensify over the next few years. Another sign that this industry is in good shape is the relatively low cancellation and deferral rates on orders. We believe that a gradual ramp-up in production by the original equipment manufacturers (OEMs) on aircraft such as the A350, A320 Neo, 737 Max and CSeries should be beneficial for the suppliers.

Lisi, a company we initiated in our portfolios a few years ago, is a global manufacturer of assembly components for the aerospace, automobile and medical markets. Lisi's origins date back to 1777, but it's only after an acquisition in 1977 that the group became active in the aerospace market. Today, 85% of its operating profit comes from the aerospace segment. Lisi holds leading positions in its markets: number three worldwide in aerospace fasteners, number one in safety components for the automobile sector and it ranks among the top five global suppliers of medical implants. The founding families and the Peugeot family control the company, owning 54% of its capital.

Market

- The global aerospace fasteners market is expected to reach \$9B by 2021, growing at around 7% per annum. The top three players (Alcoa, Precision Castparts and Lisi) control more than 80% of the market.
- Demand for fasteners in the aerospace industry is driven by several factors:
 - New aircraft production requires more fasteners (e.g. wide-body planes)
 - Air traffic and aircraft utilization is growing
 - As programs become more complex, content per aircraft increases

Growth Strategy

- Innovation in new aircraft development results in a higher content per aircraft for suppliers.
- Lisi could diversify its distribution channels by increasing the number of companies it works with. Distributors represent only 10% of Lisi's revenue at this time.
- Doing bolt-on acquisitions.
- Expanding business with existing customers and attracting new customers.

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Strengths

- Very high barriers to entry in highly regulated industries.
- The management team has proven itself capable of expanding through acquisitions that have enabled it to increase the content the company provides on a wide array of aircraft platforms.
- Lisi benefits from strong relationships with all major OEMs and enjoys a good market share.
- Lisi maintains a well-diversified customer base.
- With a strong balance sheet, we believe the company is well-positioned to increase market share and acquire smaller players in its markets.

Opportunities

- Development of new programs by aircraft manufacturers (narrow-body planes) and the acceleration of production rate.
- Excellent forward visibility with more than 12,000 new airplane orders in backlog and more than 20,000 aircraft in service worldwide that require regular maintenance.
- Lisi provides critical parts for the LEAP engine that is being developed by Safran and GE. The ship-set content is 50% higher than on a normal engine.
- Measures that have been implemented to improve profitability over the past few years should provide additional margin upside.

Risks

- A weaker aerospace cycle or an economic downturn would negatively impact the business.
- Uncertainty in aircraft production rates and delays in new aircraft development could affect revenue growth.
- Integration risk associated with acquisitions could impact the business.

Have a good weekend.

The Global Alpha Team

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