QUARTERLY COMMENTARY

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Commentary

ORLOG CAPITAL

Manager Update: July 2022
John Qiu, Founder

To consistently win any game over the long run, you either need an edge or you need to have control over the rules. This concept is well understood in gambling but often overlooked in investing. We believe the game theory aspect of investing is crucial and the Orlog Model is a direct reflection of where we see our relative advantages – our strategy for beating the market.

At Orlog Capital, we are good at finding highly asymmetric risk/reward investment opportunities. We are able to do this because of an investment process and philosophy focused on looking for value in misunderstood, ignored and often hated companies - if investing is a pricing game, that's where the mispricing is most likely to exist. To execute this strategy successfully, we set aside the prevailing, conventional wisdom and engage in fundamental research of companies and assets to build our own unique understanding using first principles. Once we find an exceptionally attractive opportunity, we back our conviction with large, concentrated investments. Operationally, Orlog Capital is structured to allow for this type of fundamental, contrarian investing which requires a high degree of tolerance for volatility, the willingness to buy 'falling knives' and the ability to wait long periods to crystallise value. We see this as our edge.

We avoid competing directly in areas where we have no relative advantage such as: trading, forecasting, timing investments, macro analysis. Also, we accept value slippage in circumstances where we identify an attractively priced investment. Typical behaviour for us include: early entry and exits, holding rather than trading positions, countercyclical portfolio positioning (net buying in bear markets, net selling in bull markets).

An example of our model at work was our investments into oil & gas companies in mid-2020 (from the predecessor portfolio which was transferred into our Fund). The breakout of covid caused a collapse in hydrocarbon demand and prices which eviscerated the valuations of all these companies. Oil & Gas was the most unloved sector in 2020 with the XLE ETF down -50% by late 2020 (vs Nasdaq 100 +30%) bringing it to its lowest level since 2004 (and -25% below trough GFC levels). Experts were predicting oil demand would never recover and that even the best global reserves were at risk of becoming stranded assets. At the time we had no idea when or how demand would recover but we were certain that the supply side was severely misunderstood and imbalanced. We bought the best companies paying a fraction of their reserve replacement cost and on low to high-single digit multiple of minimum sustainable earnings (using US$60/bbl oil price). Our contrarian bet paid off well. Our investment framework was detailed in a blog written at the time: https://www.investin1.com/post/away-from-the-crowds

While our methods are the same, we are flexible in the application. Our investment philosophy is applied successfully to everything from 'traditional value' stocks to 'modern growth' stocks. You could say we are style agnostic and value centric – to us, businesses are businesses and value is value, whatever its shape or form. We think many of our industry peers are too rigidly fixated on one particular 'thing' e.g. low multiples, high growth, tech only, 'disruptive innovation', etc. Cynically, we think most of these strategy labels are for marketing consistent messaging rather than a true reflection of any particular competence.

Our Fund has been open half a year now and performance has been satisfactory at 31% net YTD. Short-term performance figures such as these should be taken with a pinch of salt and are heavily influenced by timing coincidences, especially in today's high volatility markets. More meaningful were the Fund actions during the period which took advantage of the volatility to make significant portfolio adjustments and reduce gearing from the peak March levels. One particular company we wish to highlight is CVR Energy which is perhaps the best refinery stock we've ever come across. The management team is excellent with a strong operational track record. But where CVR Energy excels as a public company is the outstanding capital returns to shareholders: >$6/share in cash and stock (Delek US shares) distributed between 2020 and 2021 (or ~$600m of capital) which represented ~40% of CVR Energy's average share price during that period and almost half of its 2019 equity value! They did this without any compromise on business reinvestment and this type of behaviour is seen throughout their history. CVR Energy was a top five position early in the year and rapidly rerated over the past few months with the severe refining shortages. The valuation gap to other opportunities grew too extreme and we reluctantly recycled the capital into higher upside ideas. It is a company we would be happy to own again given the right price.

We are invigorated and excited by the current market. Everyone has finally sobered to the realisation that inflation is rampant, the liquidity punchbowl is being taken away and that global economic conditions are deteriorating. Headlines are miserable, fear is palatable, speculative bubbles are being crushed and no-one expects things to improve. But at the same time asset prices across the board have plummeted which has significantly de-risked the downside. The return potential of our portfolio is excellent and we are net buyers in this market.

This quarter's stock analysis will look at Spirit Aerosystems, a long-time portfolio position which we've recently resized up.

About Spirit Aerosystems

Spirit AeroSystems (SPR) is the world's largest aerostructures designer and manufacturer for commercial airplanes. It is the exclusive supplier to Boeing and Airbus on majority of its products which include fuselages, nacelles, struts/pylons and wing systems. SPR also produces aerostructures for business jets and operates Defence and Aftermarket businesses.

Boeing accounts for majority of SPR's revenues: ~80% in 2019. SPR is Boeing's largest external supplier and responsible for majority of the airframe content for its two key programs: the B737 Max and B787. Another 15% of revenues was from Airbus where the key products are wing systems for the A320 and both wing and fuselage for the A350. SPR supplies aerostructures to varying degrees for all current Boeing and Airbus planes.

With the two years of turmoil at Boeing, SPR has been actively diversifying to: a) more Airbus business, b) growing its Defence and Aftermarket segments, c) Regional/Commercial jets. It acquired various Bombardier assets for ~US$900m in enterprise value in late 2020 which increased its long-term Airbus contracts and Aftermarket business. SPR's long-term goal is to move to 40%/40%/20% Commercial/Defence/Aftermarket revenues from 79%/15%/6% in 2021.

Why has SPR fallen?

SPR was heavily impacted by the B737 Max (~53% revenue and 60-80% profits in 2019) problems, covid related disruptions and to a lesser extent, the poor demand and technical issues with widebody airplane programs: B787 and A350. SPR's price chart reflects these events:

- 3/2019: B737 Max planes grounded worldwide
- 5/4/2019: Boeing cuts B737 Max production to 42/month (from 52/month). SPR still producing 52 shipsets/month but halted the original expansion plan (to 57 shipsets/month)
- 18/12/2019: Boeing announces suspension of all B737 Max production starting 1/2020. SPR reduces planned FY2020 B737 Max deliveries to 216 (from 606 in 2019)
- 3/2020: COVID-19 declared a pandemic by WHO. Global stock markets crash
- 5/2020 and 6/2020: SPR's B737 Max FY2020 shipset delivery plan cut to 125 and then 72
- 30/10/2020: SPR completes acquisition of various Bombardier aerostructures and aftermarket businesses
- 18/11/2020: US FAA clears B737 Max
- 27/1/2021: European EASA clears B737 Max
- 5/2021: SPR increases B737 Max shipset production
- 11/2021: SPR B737 Max increased to 21/month
- 2/12/2021: China CAAC clears B737 Max
- 5/2022: SPR B737 Max increased to 31/month

However, since April SPR shares have collapsed again (-40%), falling even more than the broader market. This is related to the negative Boeing 1Q22 update which revealed:

- Inflation and supply chain issues
- No update on when B737 Max production would step up again from the current 31 planes/month
- Technical and regulatory issues on B787 and B777X

Additionally, the news coming out of China remains poor: a) covid lockdowns, b) commercial flights of B737 Max not yet resumed, c) Airbus winning a mega-order from the four major Chinese airlines. China is an important market and expected to account for 25% of total global commercial airplane orders over the next 10 years.

Sell-side have been cutting their price targets on SPR and the sentiment seems poor.

What do we see in SPR?

Commercial aircraft production will likely remain a duopoly between Boeing and Airbus in the foreseeable future. We understand SPR to be a high-quality business and an essential supplier to both. Specific aspects we like about SPR's business:

- High technology and specialised manufacturing expertise: sensitive material science knowledge and mass production processes developed in-house and alongside the client
- Exclusive, long duration contracts: sole supplier in most cases for example the B737 Max fuselage where SPR has a life-long contract from 2015 to 2033

The global commercial airplane fleet in 2022 was ~25,600 and growing at 3-5% pa (750-1,250 net new planes pa) while the estimated replacement life of airplanes is ~25years (1,000 replacement planes pa). This brings near-term annual demand for new commercial airplanes to 1,750-2,250 planes pa.

Now that the B737 Max issues have been resolved and cleared to fly by all global regulators, we think it is only a matter of time before production recovers to 2019 levels of 52 shipsets/month before rising further. Current supply side issues and China/US tensions are likely temporary delays to that recovery given: a) close similarity between Airbus and Boeing products, b) Airbus doesn't have the production capacity to takeover Boeing's market share, and c) the US government is likely to put significant weight behind supporting Boeing's domestic and international orders. With less than 1,000 planes in operation the B737 Max program is still young and we are optimistic that its best days are still ahead.

With the cost cutting and re-organisation since 2020, SPR estimates it can achieve Group OPM of 16.5% at a delivery rate of just 42 shipsets/month of the B737 Max (before it needed low 50s shipset production to achieve a similar margin). Additionally, this can be achieved despite higher rates of inflation due to:

- Labour and material inflation clauses in contracts
- Efficiencies gained from production ramp up
- Boeing and Airbus run centralised raw material buying consortiums
- Long term contracts with SPR's own suppliers

We rate SPR's management quality highly. In reaction to the operational downturn in 2020 they surprised us with the speed and magnitude of cost reductions: $1bn of costs removed by late 2020 (40% of non raw material related costs) through retrenchment (44% of workforce) and production site re-configuration/consolidation. Then in 2021 management was effective in scaling up production again and rehiring half of their previously furloughed employees. If Boeing can solve its issues, we think SPR will efficiently ramp up to higher deliveries.

We also like SPR's capital returns record. In the five years between 2015 to 2019, SPR returned ~$2.5bn of capital via buybacks (>25% of shares bought back) and dividends equating to almost 100% of its normalised earnings. SPR will likely focus on reducing debt over the next 3years but by 2025 we believe shareholders will again enjoy substantial capital returns.

Valuation

We see SPR's earnings and valuation in two parts:

1. Mean reversion in the Commercial segment driven by a recovery in B737 Max deliveries
2. Organic growth of Defence and Aftermarket businesses

Our base expectation is B737 Max production recovery to 42 shipsets/month sometime in 2023 and then 50s production level by 2024. Total Airbus orders in 2024 will likely be above 2019 levels. On this basis the Commercial segment should achieve revenues around $7-8bn by 2024 with OPM of 13-15% which equates to $910-1,200m in operating profit.

Given the momentum of Defence contract wins and the addition of the Bombardier aftermarket assets, we estimate total Defence and Aftermarket revenue growth in mid to high-teens and combined OPM of mid-teens. By 2024 total revenue should be in the range of $1.1-1.3bn and operating profit $170-200m.

After removing -$500-600m of opex plus net interest cost, we get a group operating profit of $480-900m. Subtracting 25% tax rate, the estimated NPAT range is $360-675m. We think these estimates are very conservative considering SPR was making $500-600m in net profits pre-2020 with low contribution from Defence and Aftermarket and no Bombardier assets.

SPR is likely to grow future earnings at high-single digits to low double digits and we think a fair valuation multiple for the company is around 15x PE. On this basis, our 2024 valuation is $5.4-10.1bn or $52-97/share. The 2year return CAGR equates to 31-80%.

Lastly, changes to Boeing's production schedules are typically announced 6 months in advance. We think SPR's valuation will likely re-rate ahead of time alongside the anticipated ramp up in B737 Max production. The CAGR range could be higher due to this reason.

Final Comments

We initially invested in SPR in 2020 when it was trading below $20/share. At the time the market was worried about SPR's survival given little clarity on the necessary steps and timeframe for B737 Max's resumption and large negative cash outflows. Later as the B737 Max problems were resolved, the stock price recovered, and we reduced the position weighting.

Today at less than $30/share or $3.2bn Market Cap the valuation for SPR again looks compelling and we have significantly increased our position. The risks are lower, fundamentals healthier and the solvency of SPR is no longer a major concern.

Ultimately we believe SPR is an irreplaceable company and vital to the supply chain of commercial airplanes production. We think the company has been unfairly caught in the broader market risk-off sell down and that the market may be confusing temporary with permanent impacts to SPR's business.

Portfolio Overview

ORLOG CAPITAL

Top Five Major Holdings (in alphabetical order)	
Alibaba	E-Commerce
CNOOC	Oil & Gas Exploration & Production
DADA Nexus	E-Commerce
JD.com	E-Commerce
Sands China	Casino operations

Performance	
Non Annualised Net Returns in US$[1]	
Year to date	30.9%
3 months	2.6%

1. Net of 1.5% annual management fee and 20% performance fee (excess return above 5% hurdle rate and subject to HWM)

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