Under the Hood in the Defense Sector

As more and more vile images of atrocities are coming out of Ukraine, one can be reasonably assured that defense spending is heading in one direction in the near term – up, way up. Even Canada finally got its head out of it's you know where and committed to buying some new fighter jets. The exact same jets that the Justin Trudeau led Liberal party won a majority government in 2015 in part on a campaign promise to not buy the F-35, even though Canada had been actively involved in the Joint Strike Fighter (F-35) project since 1997, committing $100's of millions to the development of the fighter jet. But not to worry, I'm sure those same jets that Canada committed to buy back in 2010, for initial delivery in 2016 won't cost the taxpayers anymore money, I say with a heavy dose of sarcasm and disappointment.

My personal rant aside, we are seeing nations around the world become increasingly unsettled by Putin's actions and are making commitments to increase defense spending. In February, the German government announced it had decided to supply €100 billion for military investments from its 2022 budget, more than double what it allocated in 2021. News like this has seen the shares of F-35 manufacturer, Lockheed Martin Corp. (NYSE: LMT), and many of its peers, rally as much as 15% since late February. But not every defense stock has rallied, especially if most investors aren't even aware that a particular stock is in the defense sector. Today we are going to take a closer look at a Canadian company that is the third largest landing gear company worldwide, with 70% of its sales coming from the defense segment. It also happens to be trading at virtually the same price it was in late February and only slightly higher than a year ago.

Héroux-Devtek Inc. (TSX: HRX) is an international company specializing in the design, development, manufacture, repair and overhaul of aircraft landing gear, hydraulic and electromechanical actuators, custom ball screws and fracture-critical components for the Aerospace market. The Corporation supplies both the commercial and defense sectors with production facilities in Canada, the United States, the United Kingdom and Spain. Approximately 90% of the Corporation's sales are outside of Canada, including about 55% in the U.S. and 28% in the UK/Europe. Note that all production and virtually all its sales are in politically stable, West-friendly jurisdictions. An increasingly important factor in today's world.

The numbers coming out of the Company are equally stable. Excluding a one time, non cash impairment charge related to goodwill as a result of a reduction in expected demand for commercial aerospace products due to COVID-19, sales, EBITDA and income have been pretty stable for the past 5 years:

5-YEAR FINANCIAL SUMMARY

(in millions of CAD $, except per share data)	FY22 Q3 YTD	FY21	FY20	FY19	FY18
Sales	388.6	570.7	613.0	483.9	386.6
Operating income (loss)	33.3	34.1	(30.1)	37.2	23.4
Adjusted EBITDA[1]	60.9	88.3	96.2	74.2	56.9
Net income (loss)	20.7	19.8	(50.7)	26.2	13.7
(Loss) Per share – diluted ($)	0.58	0.55	(1.38)	0.73	0.38
Adjusted net income[1]	20.7	29.0	35.7	30.4	24.2
Adjusted earnings per share ($)[1]	0.58	0.80	1.00	0.84	0.67

[1]These are non-IFRS measures. Please refer to the "Non-IFRS Measures" section of the MD&A

Source: Héroux-Devtek Quarterly Investor Fact Sheet

The Company trades at a P/E of 20x based on 12 month trailing income and roughly 1x sales but that includes a couple of disappointing quarters that were a result of supply chain and production system disruptions related mostly to the Omicron variant. Héroux-Devtek expects to recover these sales over the coming quarters, and that doesn't include any upside resulting from increased global defense spending. Additionally, as the pent-up demand to get back on commercial airlines start to gain traction, there could be an added tailwind to the Company’s civil business segment.

Another metric I like about Héroux-Devtek is that it is a free cash flow (FCF) machine. Over the last 2 years, the Company has a combined stock buyback and net debt reduction of $143 million. Current net debt to Adjusted EBITDA ratio is 1.8:1, with $86 million in cash at the end of 2021. Then there is the tight share structure, with only 34.6 million shares outstanding after the Company repurchased 2.2 million shares through its NCIB in the first 9 months of Fiscal 2022. All of this sets up very nicely for a quarterly result that could surprise to the upside. Albeit there is no certainty that will be the next quarter reported, but you can see a company that is in good shape for a solid quarterly beat in the not too distant future. Along those lines, in October 2021 Héroux-Devtek announced it had entered into an agreement with the aforementioned Lockheed Martin for the development of landing gears for its next generation of defense aircraft.

All in all, it appears that Héroux-Devtek has a decent forward outlook and may simply be suffering from a mild case of anonymity. Next quarterly results are scheduled for May 19th if you want to wait and see if supply chain issues have been laid to rest. But with one NATO country after another announcing increased or renewed defense spending, it may only be a matter of time before the market discovers this defense stock that hasn’t participated in the recent rally.