Roubaix Capital : Research Note – Park Aerospace (PKE)

- **Strong top line growth** - a decade of visible double-digit top line growth
- **Impressive profitability** - high teens EBIT margins moving to 20%+
- **Overcapitalized** - net cash per share of $6.50 creates upside optionality
- **Undiscovered** - no sell-side analyst coverage and recent dramatic change in business
- **Undervalued** – large discount to peers at less than 15x FY2 EPS excluding cash
- **Distinguished capital stewardship** - paid $25 in cumulative dividends since 2005

Park Aerospace (PKE) is a new company that is 65 years old. If you have not heard of Park Aerospace, the reason may be that the company changed its name earlier this year from Park Electrochemical, and for good reason. The low margin legacy electronics manufacturing business was sold in late 2018, clearing the way for the company to become a pure-play advanced composite materials supplier to global aerospace markets. PKE now has a decade of top line visibility, a margin profile that is already approaching 20%, and a management team with a remarkable track record - the company has paid out almost $25/share in cumulative dividends since 2005 vs. its current $16 share price, including a $4.25 special dividend in February 2019. Yet with only $200 million enterprise value and zero sell-side analyst coverage, PKE has fallen under the radar and is currently 30-50% undervalued on reasonable multiples for a company of its quality.

The most important business line for PKE is their sole source long-term agreement (LTA) through 2029 to supply advanced composite material to LEAP-1A engines on Airbus A320neo and A321neo aircrafts. Airbus is currently building 60 aircraft per month, moving to 65 per month by 2022, providing a decade of clear visibility on this single program. Of note, PKE is not a supplier to the LEAP-1B engine used on Boeing 737 MAX, so has not been affected by that program’s grounding this year. Under the same LTA, PKE supplies the LEAP-1C and CF34-10A engines for Comac, China’s state-owned aircraft manufacturer, as well as the GE Passport 20 engines for Bombardier’s new fleet of business jets. With several of these programs getting underway, PKE does not expect this jet engine LTA to reach full production until calendar 2025 at the earliest.

In addition to the jet engine business, the company sees several opportunities for incremental organic growth. PKE is a supplier for Kratos’ (KTOS) Target and Tactical Unmanned Aerial Systems to provide certain composites for their drone program and should see further demand from defense companies across several categories. PKE is also in the process of qualifying certain components of the new GE9X engine for the expected 2020 introduction of the Boeing 777X wide body airplane, which would be incremental to their current jet engine LTA described above. Lastly, management recently announced an initial purchase order from a private space program that could open yet another end market that is not included in the company’s long-term forecasts.

PKE expects current fiscal year 2020 (Feb. ‘20) sales to be approximately $60mm. At this modest level, they expect an impressive high teens operating margin. Going forward, the company anticipates 15%+ annual organic growth through FY2023. This strong and consistent top line growth is expected to drive margins to at least 25%, a level at which very few companies operate. Less than 10% of companies in the Russell 2000 Index deliver a 20% EBIT margin. Within the GICS industrials sector, that number falls to 5%. If rental and leasing companies from the industrial sector are excluded, just six companies earn a 20% or higher operating margin. Combined with a significant net cash position and several years of mid-teens sales growth, PKE is truly a unique investment opportunity.

Despite all of these qualities, PKE currently trades at just 15x the company's estimated FY2 EPS and less than 12x FY3 estimated EPS, when excluding the net cash and requisite interest income. This math assumes the company simply pays out a further $6+ dividend, in line with their remarkable track record of $25 per share cumulative dividend since 2005. Alternatively, investors could realize incremental upside if the company instead deploys that cash toward accretive M&A. PKE's M&A process is being aided by their OEM customers who have introduced them to companies where they see a strategic fit. This creates a much more attractive opportunity set than what is seen in larger competitively marketed deals. If PKE deploys $50 million of their $145 million in cash at a 15% IRR, it would add approximately $0.25 annual earnings. At a 20x multiple, this offers an incremental $5 per share of value (+30%) on every $50 million allocated to such accretive M&A. As a point of reference, the ROIC of the company's current aerospace business exceeds 20%.

For comparative valuation purposes we highlight both aerospace peers and high margin industrial companies with clean balance sheets in the tables below. For the sake of simplicity, however, we will focus on Hexcel (HXL) as the closest direct competitor to PKE's aerospace composite business. Forward expectations for HXL are for 10% top line growth and an operating margin under 20%, along with almost 3x leverage. With higher growth, higher margins, and an overcapitalized balance sheet we believe PKE should trade at a premium to HXL's current ~20x FY2 EPS multiple. Add to that more than $6.00 net cash per share and fair value of PKE shares is $20-24 at 22-25x FY2 earnings, for a return of +25-50%. If we roll forward valuation to a third year of expected 15% top line growth, the return potential increases to +40-70%. Likewise, if we utilize peer average valuation rather than just HXL, potential returns move even higher.

Investing in PKE does bear risks. First, the company is small in terms of total revenue and enterprise value. This makes any headwinds in the business more impactful to the P&L and the stock price. In the most recent quarter, supply chain constraints were challenges. Similarly, PKE has high customer concentration risk, with half of its business wrapped up in a single jet engine LTA. While Park does not have direct exposure to the production delays for the Boeing 737 MAX, it highlights the risk in these massive projects. Lastly, two members of the senior management team are family. While their track record and contributions have been clearly positive to date, it is a factor to take into account.

In summary, PKE is a fast growing, high margin, well capitalized company operating in an excellent industry with years of visibility. The management and board have done an exceptional job getting the company to this point, all while returning and extraordinary amount of capital to shareholders along the way. The stock has meaningful upside on reasonable assumptions as well as upside optionality from a higher level of execution and M&A. The risks the company bears are reasonable considering and relative to the strong balance sheet.

PKE Forecast ($ Millions, February Fiscal Year End)

	FY20	FY21	FY22	FY23		FY21	FY22	FY23		FY21	FY22	FY23
Sales					**Growth**				**EV/Sales**			
High	$60.8	$73.0	$84.0	$92.0	High	20.2%	15.1%	9.5%	High	2.7x	2.2x	1.8x
Mid	$59.8	$71.0	$81.0	$89.5	Mid	18.8%	14.1%	10.5%	Mid	2.8x	2.3x	1.8x
Low	$58.8	$69.0	$78.0	$87.0	Low	17.4%	13.0%	11.5%	Low	2.9x	2.4x	1.9x
EBITDA					**Growth**				**EV/EBITDA**			
High	$13.0	$21.0	$24.5	$27.5	High	61.5%	16.7%	12.2%	High	9.5x	7.5x	6.0x
Mid	$12.5	$19.3	$23.0	$26.3	Mid	54.0%	19.5%	14.1%	Mid	10.4x	8.0x	6.3x
Low	$12.0	$17.5	$21.5	$25.0	Low	45.8%	22.9%	16.3%	Low	11.4x	8.6x	6.6x
EPS (ex-Interest Income)					**Growth**				**P/E (ex-Net Cash)**			
High	$0.41	$0.70	$0.80	$0.91	High	69.1%	15.4%	13.3%	High	13.7x	10.9x	8.7x
Mid	$0.39	$0.63	$0.75	$0.87	Mid	60.9%	18.3%	15.5%	Mid	15.0x	11.7x	9.1x
Low	$0.38	$0.57	$0.70	$0.82	Low	51.9%	21.9%	17.9%	Low	16.7x	12.6x	9.6x
Net Cash	$6.67	$6.80	$7.57	$8.46								
ROIC	20%	23%	27%	29%								

AEROSPACE PEER GROUP

FY2 Valuation	**PKE**	***Peer Avg***	***Relative***	**HEI**	**HXL**	**AIN**	**CW**	**B**	**WWD**	**KTOS**
EV/S	2.8x	*3.3x*	*-14%*	7.8x	3.0x	2.6x	2.3x	2.2x	2.5x	2.6x
EV/EBITDA	10.4x	*15.7x*	*-34%*	29.4x	12.3x	10.9x	11.2x	10.0x	12.6x	23.3x
P/E	15.0x	*28.4x*	*-47%*	47.9x	19.6x	22.5x	16.7x	15.2x	19.3x	57.4x
Other Information										
Leverage	-12.2x	*1.8x*	*n/a*	1.1x	1.9x	1.2x	1.1x	2.5x	2.3x	2.4x
LTM EBIT Margin	17.6	*15.2*	*16%*	22.4	18.4	17.1	15.7	15.0	11.6	6.1
FY1 Sales Growth	15.5	*12.0*	*29%*	14.8	10.9	8.2	4.9	2.3	25.0	18.0

HIGH MARGIN INDUSTRIAL PEER GROUP

FY2 Valuation	**PKE**	***Peer Avg***	***Relative***	**TREX**	**EXPO**	**ROLL**	**PRLB**	**ERII**	**SSD**	**AAON**
EV/S	2.8x	*5.0x*	*-44%*	6.1x	8.3x	4.9x	5.0x	3.9x	2.6x	4.4x
EV/EBITDA	10.4x	*18.4x*	*-44%*	21.4x	29.9x	18.6x	17.5x	10.3x	12.8x	18.8x
P/E	15.0x	*28.2x*	*-47%*	31.6x	38.6x	28.0x	30.5x	16.3x	21.7x	30.6x
Other Information										
Leverage	-12.2x	*-1.5x*	*n/a*	-0.6x	-2.1x	0.0x	-1.2x	-5.4x	-0.7x	-0.2x
LTM EBIT Margin	17.6	*18.7*	*-6%*	22.9	22.4	21.1	18.4	16.7	14.7	14.7
FY1 Sales Growth	15.5	*8.6*	*80%*	10.4	8.8	7.1	5.5	13.0	2.9	12.6

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