EAGLE
CAPITAL MANAGEMENT

THIRD QUARTER 2024

Macroeconomics makes for fun cocktail party chatter. Provocative views on elections, oil prices, artificial intelligence, and geopolitics are catnip on CNBC or Twitter. However, speculation and hot takes are the antithesis of Eagle's investment strategy. Our idea engine is firmly rooted in studying the microeconomics of specific industries and firms.

Whether you're someone who loves reading about stocks or someone who figures that's our job, we hope you'll find a deep dive into one of our portfolio companies, Woodward, interesting and useful. It sheds light on our process and is illustrative of the kind of companies we seek.

First, a caveat. Predicting the future isn't hard, it's impossible. We get things wrong with every company we invest in. Sometimes, the errors bend in our direction, and sometimes, they bend against us. For example, our internal earnings forecasts strive for accuracy rather than cautiousness. We would prefer to make our best estimate and then decide on a conservative price we're willing to invest at than encourage analysts to use numbers they're almost certain the company can beat. And unexpected developments happen all the time. Investing is not a static process.

As a result, the below reflects our best thinking and enthusiasm for Woodward as of today. We may own it for a decade or more. It's also possible—albeit unlikely—that we will decide to exit a few months from now. As the future unfolds, we try not to get too anchored to what we thought in the past.

Woodward, Inc.

Woodward is a mission-critical supplier of components and systems used in the aerospace and industrial sectors. We believe aerospace is one of the most attractive segments of the global economy. The company has a unique growth story within this industry. Design wins have allowed it to triple the dollar value of the components it manufactures for the new generation of narrowbody aircraft—predominantly the Airbus A320neo and the Boeing 737 Max. Narrowbody aircraft are the backbone of commercial aviation, flying most domestic routes as well as shorter international ones. Because it takes decades for the global fleet to turn over, the economic impact of these wins on aftermarket revenue has scarcely begun.

These share gains should allow Woodward to outgrow competitors during the next decade and post EPS growth in the mid-to-high-teens. In addition, its earnings mix should improve over time as it becomes more concentrated in the aerospace aftermarket. This may cause investors to give it a premium valuation. Despite this outlook, Woodward trades at a discount to peers at a low 20s multiple of 2025 free cash flow.

Business and Industry Overview

We estimate that 70% of Woodward's profit next year will come from aerospace and 30% from industrial. Within aerospace, 57% of segment profit comes from commercial aftermarket, 13% from new commercial aircraft, and 30% from defense.

Aerospace is an attractive end market. The demand side exhibits growth well above that of the overall economy. From 1970-2020, global passenger traffic grew at a 6% CAGR. This increase was driven by a rising global middle class, the continued buildout of global airport infrastructure, and the expansion of low-cost airlines. Despite this growth, nearly 80% of the world's population has never flown on an airplane.

The supply side exhibits strong moats supported by technical differentiation, regulation, and 20-year platform cycles. Components must be certified by the FAA, and leasing companies also have strict mandates. These forces lead to strong pricing power.

Woodward supplies critical engine components to both CFM, a joint venture between GE and Safran, and Pratt & Whitney. These products include fuel pumps, fuel metering units, actuators, air valves, fuel nozzles, and thrust reverser actuation systems. In essence, Woodward's components support the nervous system of an airplane, translating pilot inputs into precise mechanical actions and ensuring that all parts work together smoothly.

Woodward's products are typically sole-sourced, meaning it is the only company supplying the part once a system is selected for a plane or engine. The company makes modest profits selling the original equipment and higher margins selling replacement parts. Because a given model is sold for two decades, this translates to a more than 40-year aftermarket period over the platform's life, resulting in high predictability and pricing power.

Woodward's technical capabilities in engine controls are unmatched. Our diligence indicates that GE tried to insource some of these capabilities but could not match Woodward's technical prowess. Pratt & Whitney uses several Woodward parts even though its sister company, Collins, sells competing ones.

Within its industrial segment, Woodward sells into three primary end markets: 1) transportation (marine, natural gas trucks, and off-highway equipment), 2) power generation (natural gas turbines and diesel power systems), and 3) oil & gas.

Investment Thesis

Woodward's tripling of its content share on the new generation of narrowbody aircraft is a unique growth driver versus industry peers. Current financials understate the company's potential earnings power because new generation aftermarket revenue has yet to come in, a dynamic that is about to change. The early A320neo and 737 Max aircraft are just beginning their initial scheduled engine overhauls. Over the next decade, Woodward should durably outgrow its market as older aircraft retire and the fleet transitions to this new generation.

Aerospace industry aftermarket revenue should grow high single digits over time, comprised of ~4-5% passenger traffic and 3-4% price. On top of this, Woodward's content gains should contribute another 5%, leading to low double-digit civil aerospace aftermarket growth.

This aftermarket revenue growth comes with attractive incremental margins, likely 45% or higher. Compared to aerospace segment margins of ~20% and overall company operating margins of ~15%, this mix shift should lead to significant margin expansion. We expect aerospace segment margins to expand from ~20% to ~28% over the next decade, with overall company margins increasing from ~15% to 23%. There is further margin upside from additional pricing actions, which we believe are a core focus of Woodward's new management team.

Over time, we expect aerospace's contribution to Woodward's earnings to increase from 70% to more than 80%, and aftermarket to shift from 57% of aerospace profit to 70%. This increase in aerospace aftermarket exposure should reasonably lead to multiple expansion. The public markets have rewarded commercial aftermarket-focused companies like Transdigm, GE, and Heico with high multiples, which trade at 32x, 32x, and 60x EPS, respectively.

Eagle initially invested in Woodward during the early stages of the pandemic. The stock market extrapolated a temporary travel disruption as a permanent situation. Later, the company faced supply-chain disruptions and inflation shocks that pressured its P&L and further pushed out its recovery. These challenges had little impact on our view of its long-term earnings power, enabling Eagle to build our position.

Because Woodward is relatively underfollowed, it has occasional stock price dislocations, which can offer good opportunities. For example, the stock declined more than 15% on a soft earnings report in the most recent quarter, and we were able to add more to our investment. With Boeing machinists recently on strike, we would not be surprised to see aftershocks from that disruption. None of this should affect multiyear earnings.

Woodward is transitioning from a good business to a great business. It was once a company that, when compared to peers, grew its aerospace business in-line, had more exposure to industrial end markets, had below-average margins, and had correspondingly higher earnings volatility. It deserved to trade at a discount. Looking forward, we expect its aerospace segment to grow at a premium to peers. Industrial end markets will become less relevant, margins will significantly rise, and earnings volatility will decline. It shares commonalities with our investments in Marriott and Hilton as they transitioned from more volatile and capital-intensive businesses to the high-growth, high-margin fee companies they are today.

Management

In 2022, Woodward brought on CEO Chip Blankenship, who we believe is an excellent fit. He is well-suited to maximize the company's long-term opportunity, both operationally and financially. He has a successful track record in aerospace and industrial businesses, having spent 24 years at GE and leading its commercial aviation division.

Blankenship has meaningfully improved Woodward's operations and commercial execution, particularly around pricing, which had underperformed under prior leadership. He has also driven lean manufacturing practices to reduce unnecessary SKUs and create more consistency in the production process, an emphasis that has yielded strong results. Aerospace segment margins increased by approximately 400 basis points from 2022-2024, and industrial margins increased by more than 800.

We expect Blankenship to continue these initiatives, driving further margin upside. He recently told investors, "We're still in the early innings of this journey. I don't know whether it's inning two or inning three, but we're not at the halfway point, and we're not at the seventh inning stretch by a long shot. We have numerous value streams under transformation."

Prospective Returns

Over the coming 5-10 years, we believe that Woodward can compound revenue at high single digits with margin expansion, leading to low-teens operating profit growth. The company can use its prodigious free cash flow to repurchase stock, enabling EPS growth in the high teens. Because Woodward trades at a discount to peers and in line with the overall market, valuation risk is limited. The stock's return should roughly track with earnings growth.

In the downside case, where the company doesn't execute as well as we expect, strategic buyers may be interested in acquiring it. Just as we are, larger aerospace firms are attracted to Woodward's premium aftermarket growth. Moreover, an acquirer could use its scale to drive higher margins.

Investing in Woodward is analogous to owning an expanding set of royalties on global air travel. Cashflow streams with this high level of certainty should rationally be priced at a low discount rate, offering investors a skinnier return for taking less risk. Yet Woodward is priced the opposite.

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Ultimately, strong companies, not soundbites, drive lasting returns. Woodward exemplifies what we seek: well-managed businesses with leading positions, promising long-term growth, and enough complexity to leverage our research advantage. We assemble a portfolio of these investments, knowing that even the best individual idea can disappoint. Thank you for your continued trust and support as we execute this strategy on your behalf.

As always, if you have any questions or would like to discuss anything herein, please call us at (212) 293-4040. Also, if your financial situation or investment objectives have changed, if your IPO eligibility or U.S. Person status has changed, or if you would like to modify or discuss any investment restrictions or guidelines, please reach out to your contact on the client team or email ClientServices@eaglecap.com.[1]

Please note that Eagle Capital is moving. Starting October 28th, Eagle Capital's address will be 65 East 55th Street, 26th Floor, New York, NY 10022.

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[1] Eagle Equity Composite holdings during Q3 2024 were as follows: AA; AER; AMZN; AON; BAYRY; COF; CHTR; CMCSA; COP; DFS; ELV; GEV; GOOG/L; GS; HLT; HUM; LBRDA/K; LNSTY; META; MSFT; NFLX; OXY; PROSY; SAFRY; SAP; SHEL; TSM; UNH; V; WFC; WWD; and WDAY. The following entities are not currently held in the Eagle portfolio, and reference to these entities is included solely for informational and discussion purposes: GE, Transdigm, Heico, and Marriott.

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