Kennedy Capital Management®

Flying Under the Radar:

Opportunities in Commercial Aerospace

The commercial aerospace market is familiar to most with personal travel experiences, but less well known is the fact that this industry has produced some of the greatest investment opportunities over the past twenty years. For example, companies like HEICO Corporation (5,448% 20 year return) and TransDigm Group Incorporated (5,513% since March 2006 IPO) demonstrate the potential for value creation in this sector.[1]

The commercial aerospace sector continues to offer compelling investment opportunities due to a post-COVID constrained supply of new aircraft and a robust long-term demand outlook. Original equipment manufacturer ("OEM") production is poised to accelerate, and fixed cost leverage on higher volumes should drive a multi-year backdrop of growth and margin expansion potential for the supply base.

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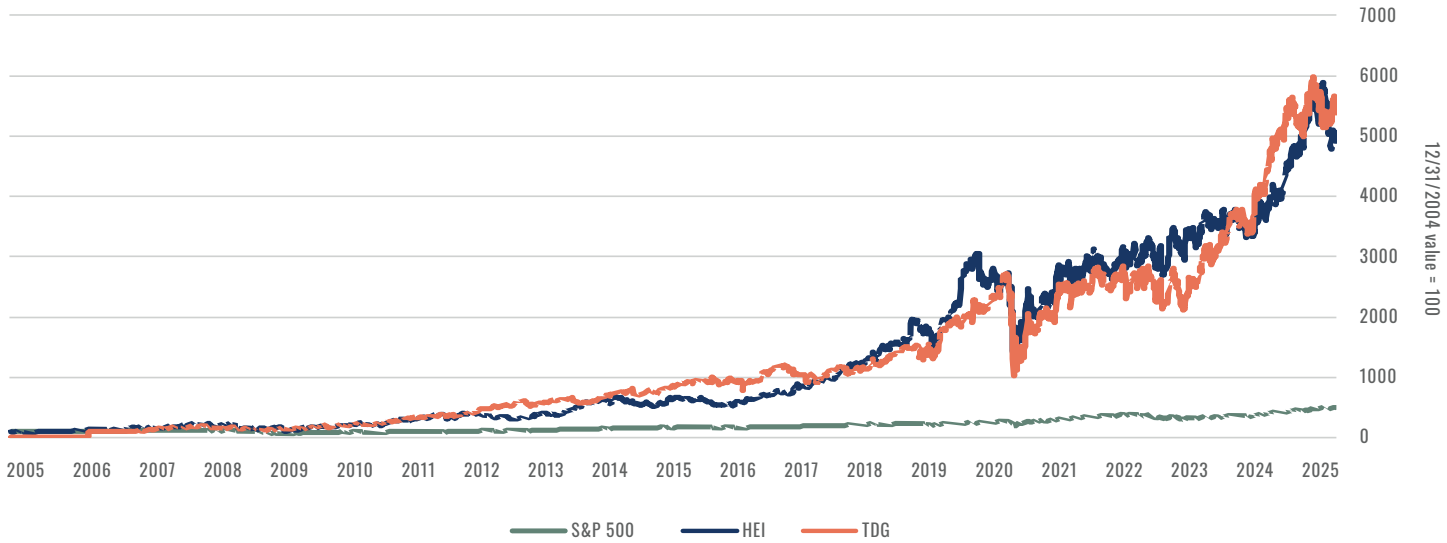
Indexed 20 year returns for HEICO, TransDigm, and the S&P 500



Source: FactSet Research Systems Inc.

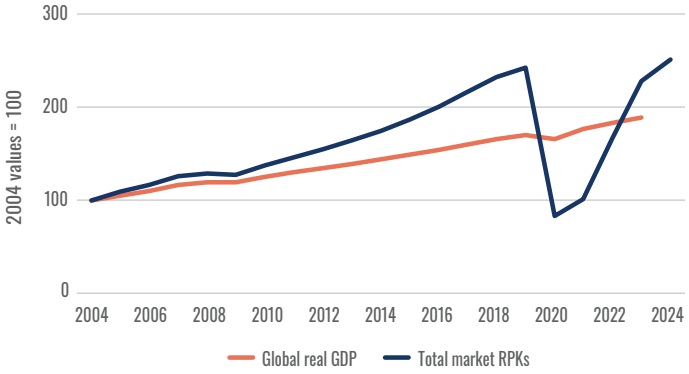
[1]While their business models remain attractive, past performance is no guarantee of future performance. HEICO Corporation and TransDigm Group Incorporated have larger market share today than they did 20 years ago, which may make future returns less robust than past returns. The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities. The index includes 500 leading companies and covers approximately 80% of available market capitalization. Investors cannot invest directly in an index.

Industry Characteristics

There are four defining characteristics of the commercial aerospace market:

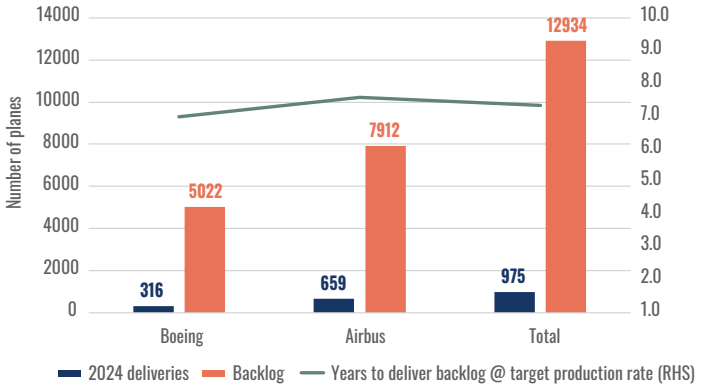
1. Large addressable market: the duopoly of Boeing and Airbus reported $78 billion in commercial aircraft sales in 2023.
2. Long term growth potential tied to the expansion of the middle class globally.
3. High barriers to entry driven by product complexity, significant development costs, long product cycles (often 2-3 decades between new plane designs), and regulatory oversight.
4. Long duration (30+ years), high margin aftermarket revenue streams created by regulated maintenance cycles, intellectual property ("IP") protection, and infrequent product redesigns.

Global real GDP vs Revenue Passenger Kilometers (RPKs), indexed to 2004



Source: International Monetary Fund 2024, FactSet Research Systems, Inc.

Boeing and airbus backlog for the 737 MAX, 787, A320, and A350



Source: The Boeing Company 2025, Airbus SE 2025, Flight Global (Boeing's 2024 Orders and Deliveries Slipped as Airbus Widened edge), Flight Plan by Forecast International 2024

One of the attractive investment qualities of the market is consistent growth, underpinned by increasing per-capita income globally. Over the last 20 years, air travel demand has consistently grown well above global GDP and is projected to continue to increase. The International Air Transport Association (IATA) forecasts a 3.8% compound annual growth rate in passenger volumes from 2023-2043[2], which is likely to exceed global GDP growth rates that have averaged around 3% over the last decade.

These growth forecasts are supported by record order bookings at Boeing and Airbus. For the four most popular plane models (representing >90% of the industry), the backlog stands at nearly 13,000 planes—13 times greater than what Boeing and Airbus delivered in 2024. Assuming no new orders and at targeted annual build rates for these models, which Boeing and Airbus are not planning to reach for at least 2 years, it would take 7-8 years of production for Boeing and Airbus to clear their backlog. This means industry suppliers may have 10+ years of visibility into the demand for new planes.

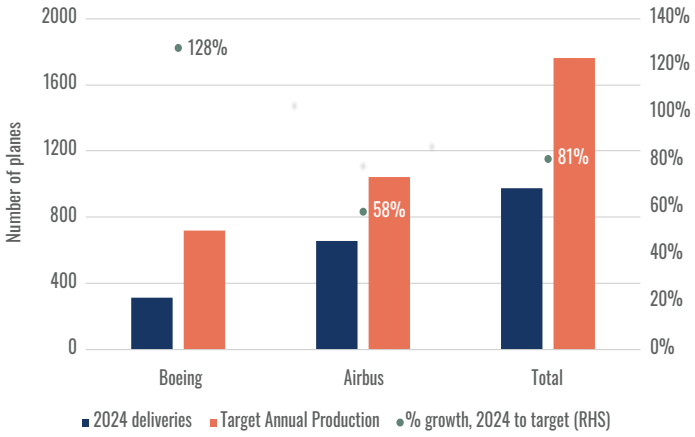
The record backlog is partially due to strong orders to meet future demand, and partially due to supply chain constraints as the pandemic was extremely disruptive to the industry. Work stoppages, labor shortages, quality control lapses, and material shortages have made it more difficult than expected for Boeing and Airbus to produce at the rates they have been aiming for. Because both Boeing and Airbus are producing well below target levels for their four most popular models, suppliers expect to see strong growth in new aircraft deliveries in the coming years as the production system improves.

[2] As measured by the IATA in revenue passenger kilometers ("RPKs"). RPKs measure the volume of passengers carried by airlines by multiplying the number of revenue passengers by the distance traveled.

While production rates have been hindered, air travel demand has strongly rebounded from the COVID-lows.

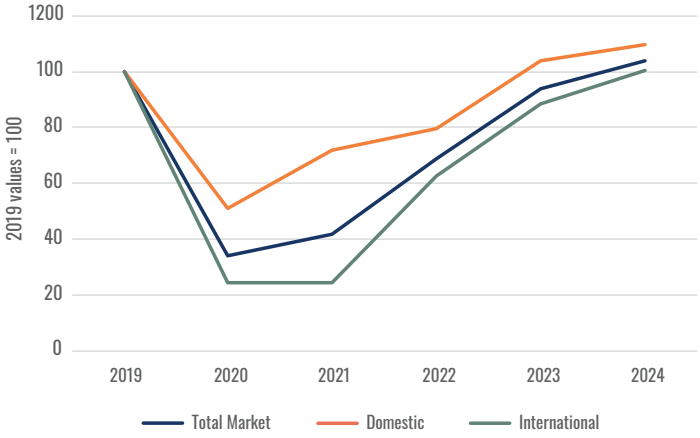
This has caused the average age of the existing fleet to reach record highs, creating what we see as favorable dynamics for suppliers of aftermarket parts and services, and increasing the urgency at Boeing and Airbus to raise production rates for new planes.

Boeing and airbus production rates for the 737 MAX, 787, A320, and A350



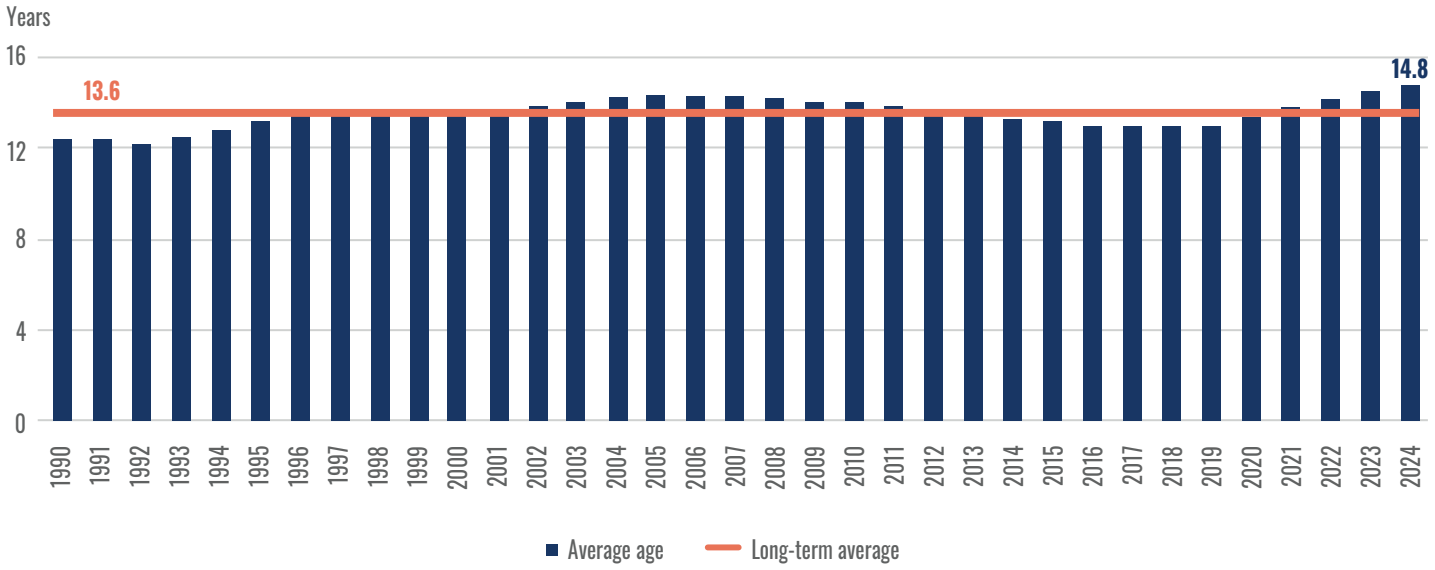
Source: Boeing 2025, Airbus 2025, Flight Plan by Forecast International 2024

Year-on-year RPK growth with 2019 as the base year



Source: FactSet Research Systems Inc.

Average age of global commercial fleet



Source: IATA Sustainability and Economics using data from Cirium

Business Models

Modern commercial airplanes have hundreds of thousands of individual parts. Some of these parts are more commoditized, such as bolts, nuts, rivets, and screws. Others are difficult to manufacture but have limited IP, like the wing or fuselage structures. Finally, some of the more complex components are highly proprietary, often sole-sourced parts, including electronics, sensors, valves, fuel assemblies, and aircraft controls. Suppliers to Boeing and Airbus that make these parts can generally be divided into two groups:

1

Build-to-print manufacturers: Suppliers of structures and commodity components for OEMs that typically do not carry significant product IP or benefit from meaningful aftermarket sales. As a result, these businesses are often more cyclical and lower margin than the second type of business group further described. However, manufacturing expertise, on-time delivery and quality, and qualification with key OEMs are barriers to entry that allow these companies to earn attractive returns on invested capital ("ROIC").

2

Proprietary component manufacturers: IP-rich suppliers that design and manufacture components including sensors, controls, electronics, and other parts that typically have a significant aftermarket revenue stream. The aftermarket business is long duration, less cyclical, and higher margin due to IP protection. HEICO and TransDigm have been successful in this category, gaining share through developing and acquiring products with significant aftermarket revenue streams, delivering excellent execution, incentivizing employees correctly, and exhibiting price discipline.

For both supplier groups, ROIC tends to be well above the cost of capital, but is typically higher for the proprietary component manufacturers. As a result, equity investors are generally willing to pay a premium for those businesses relative to the build-to-print manufacturers.

At Kennedy Capital Management, we believe there are investment opportunities in both types of businesses, as each can demonstrate the characteristics of a compelling investment case: high and rising ROIC, opportunities to reinvest capital for growth, and a valuation we believe underappreciates the ROIC and growth potential. Specific to commercial aerospace, we have often found the following situations can make attractive investment opportunities:

1

Hidden gems: In the small cap domain, we often find companies that have highly valuable IP that is being masked by some other issue. Some examples would include an underperforming division, ineffective management, or a substandard capital structure. The value of the "hidden gem" can often be unlocked by new management, a simplification of the business, or even an acquisition of the whole company by a strategic or financial buyer.

2

Serial acquirers: Companies with high and rising ROICs that have the balance sheet capability and management skills to also grow via acquisition at prices that are attractive for shareholders. The aerospace industry has seen significant M&A activity in the last two years. In the public markets alone, select transactions among evolving public aerospace companies since the start of 2023 totaled over $24 billion. (**See p.7**)

3

Differentiated assets with secular share gain opportunities: One example is in composite materials, namely carbon fibers, which are lighter in weight and stronger than traditional metals such as aluminum. These materials are more heavily used on long-haul twin-aisle planes like the Boeing 787 and Airbus A350, and we see these materials as a strong share gainer in the medium to long term, particularly on next-generation single-aisle aircraft. Suppliers of composite materials and structures should also see strong cyclical growth in the near-term as build rates at Boeing and Airbus climb to target rates.

Acquiring Company	Ticker	Acquired Company	Announce Date	Transaction Value ($M)
VSE Corporation	VSEC	Desser Tire & Rubber Co. LLC	03/04/2023	$124
TransDigm Group Incorporated	TDG	Calspan Corp.	03/14/2023	$725
AAR CORP	AIR	TRAX USA Corp.	03/20/2023	$140
Ducommun Incorporated	DCO	BLR Aerospace LLC	03/21/2023	$115
HEICO Corporation	HEI	Wencor Group LLC	05/15/2023	$2,050
KKR	N/A	Circor International, Inc.	06/05/2023	$1,600
Barnes Group Inc	B	MB Aerospace Holdings Ltd	06/05/2023	$740
AAR CORP	AIR	Triumph Group Product Support	12/21/2023	$725
Crane Company	CR	Vian Enterprises, Inc.	01/03/2024	$103
Arcline Investment Management LP	N/A	Kaman Corp.	01/19/2024	$1,800
VSE Corporation	VSEC	Turbine Controls, Inc.	02/29/2024	$120
TransDigm Group Incorporated	TDG	Raptor Scientific LLC	05/28/2024	$655
Boeing	BA	Spirit AeroSystems Holdings, Inc.	07/01/2024	$8,300
Loar Holdings Inc	LOAR	Applied Avionics LLC	07/19/2024	$385
Apollo Global Management Inc	APO	Barnes Group Inc.	10/07/2024	$3,600
VSE Corporation	VSEC	Kellstrom Aerospace Group, Inc.	10/15/2024	$200
Warburg Pincus and Berkshire Partners	N/A	Triumph Group, Inc.	02/03/2025	$3,000
Total transaction value, select M&A				**$24,382**

Source: FactSet Research Systems, Inc. 2025

Why now?

At Kennedy Capital Management, we believe commercial aerospace remains a highly attractive market for investment today due to the potential for high and increasing returns on invested capital and supportive industry dynamics over the next 5-10 years. Currently, we see notable opportunity in stocks that are more levered to rising OEM production levels. Companies with greater aftermarket exposure have experienced high growth rates as air travel demand recovered post-COVID while new plane production was constrained, leading to more maintenance on the existing fleet. Those growth rates appear to be normalizing. Conversely, suppliers that sell primarily to OEMs have seen lower growth rates as Boeing and Airbus have struggled to expand production. Rising build rates at OEMs and the accompanying fixed cost leverage should create strong earnings growth for these suppliers over the next several years. Additionally, we believe the enormous backlog of planes will likely extend the typical OEM build cycle once peak production rates are achieved. Finally, we believe there is a secular share gain opportunity in areas such as composite materials that could come into play in the years ahead as plans for next-generation single-aisle plane designs progress.

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