Fairlight
Asset Management

Global Small & Mid Cap Fund

High Conviction Ideas in the Fairlight Fund

July 2020

Investment team

Nicholas Cregan

Nicholas is a **Portfolio Manager** of the Fairlight Global SMID Fund.

Investment Experience: 17 years

- **E&P (2014 – 2017):** Portfolio Manager. Awarded "Best Global Fund" in 2016 with top decile performance since inception
- **Schroders (2006 – 2013):** Senior Analyst of the US$7bn Small Mid Cap Fund covering 25% of fund assets. Portfolio Manager AUS Micro Cap Equities (11% pa out performance over five years)

Qualifications

- Bachelor of Business (Accounting, Law)
- FINSIA Applied Valuation, UTS Fin Cert. Dip. Derivatives

Ian Carmichael, CFA

Ian is a **Portfolio Manager** of the Fairlight Global SMID Fund.

Investment Experience: 12 years

- **Watermark (2017 – 2018):** Portfolio Manager
- **Platinum (2013 – 2017):** Team leader of Consumer team, managing a $100m sleeve. Analyst coverage of healthcare sector.
- **MLC (2008 – 2013):** Senior Analyst & PM at MLC Multi Asset.

Qualifications

- Bachelor of Chemical Engineering & Masters of Biomedical Engineering
- Chartered Financial Analyst

Will Dowd, CFA

Will is responsible for **investment analysis** and **database design**.

Investment & Analytics Experience: 9 years

- **E&P (2015 – 2017):** Global equity analyst
- **Ernst & Young (2011 – 2015):** Senior Consultant (data analytics & advisory)

Qualifications

- Bachelor of Business Systems
- Masters of Finance
- Chartered Financial Analyst

Alvise Peggion, CFA

Alvise is responsible for **investment analysis.**

Investment Experience: 8 years

- **Forager Funds Management (2013 – 2019):** Global equity analyst

Qualifications

- Bachelor of Finance (1st Class Honours)
- Chartered Financial Analyst

Overview

Fairlight Small & Mid Cap Fund	Parameters
Stock numbers	30-40
Market capitalisation	US$500m-$20bn
Style	Long only quality
Maximum cash	20%
Objective	8-12% through cycle / capital preservation
Benchmark	MSCI World SMID AUD (Net)

Distribution

PERENNIAL

Administrator

MAINSTREAMBPO

Auditor

EY

Responsible Entity

Perpetual

Hedging

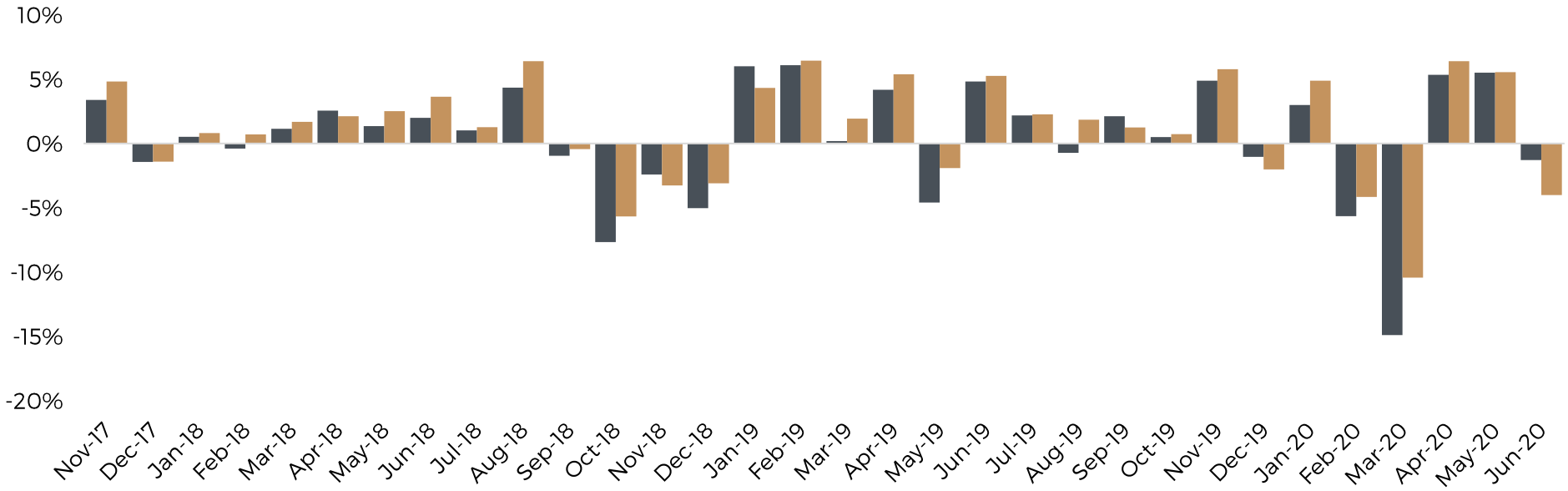
STATE STREET

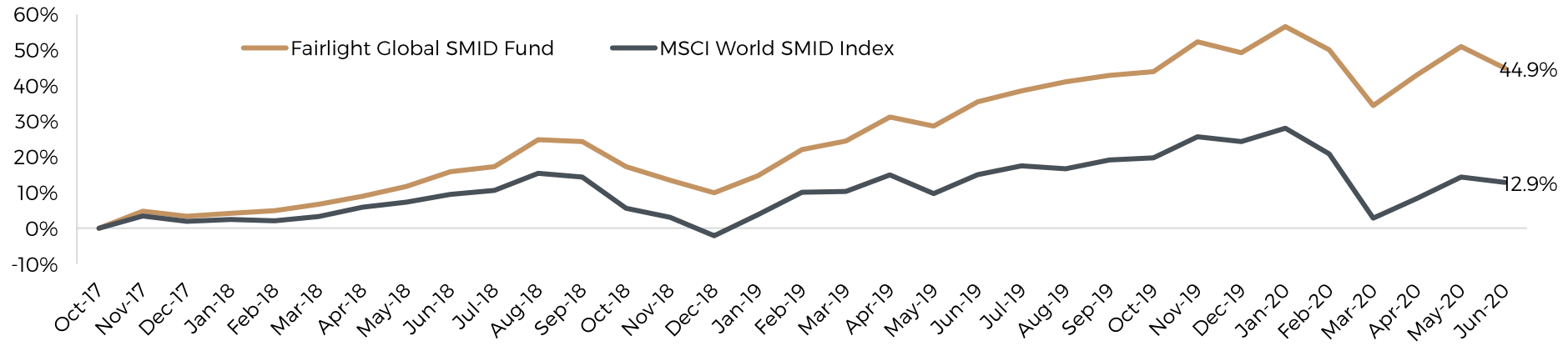
ESG

Signatory of:

PRI Principles for Responsible Investment

Fairlight track record





June 2020

FAM: -4.0%
Benchmark: -1.3%
Outperformance: -2.7%

Return Profile

Upside capture: 123%
Downside capture: 68%

10.3% p.a outperformance since 1st of November 2017

Source: FactSet Portfolio Analytics. Returns are since inception (November 1st 2017), net of fees and indicative only.
Past performance is not a reliable indicator of future performance

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Investment Philosophy

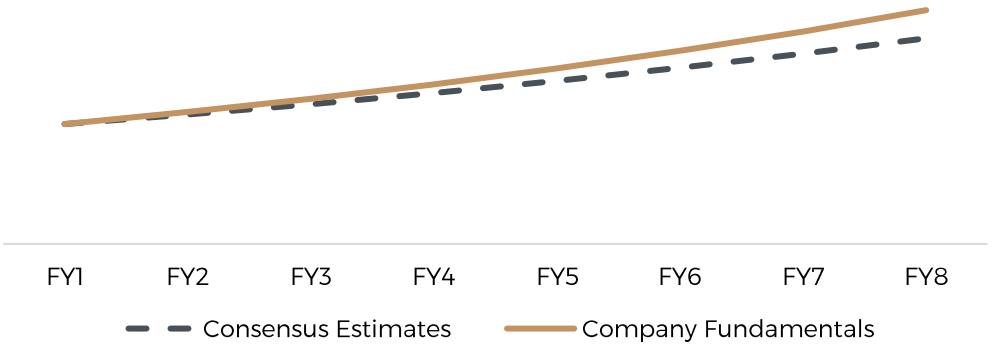
Our investment opportunities defined

1. High quality growth companies
   - Network effects
   - High ROIC growth capex

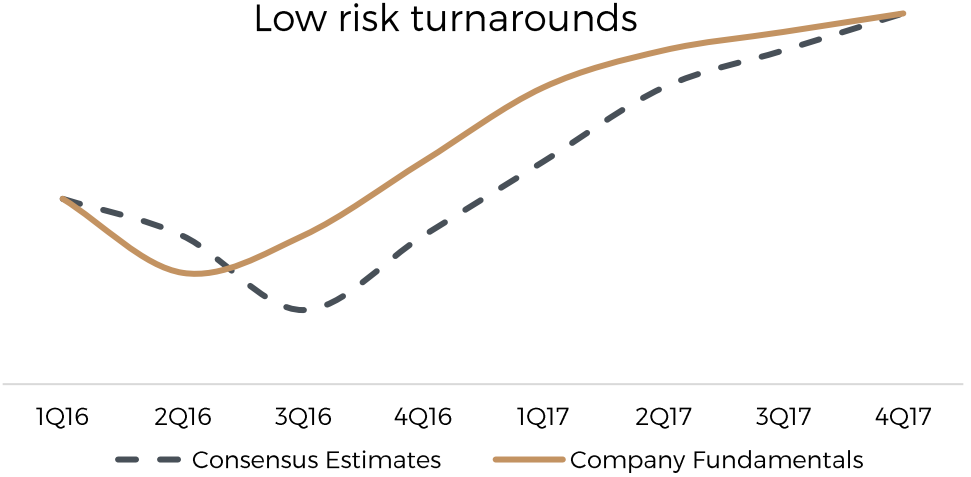
2. Stable compounders
   - Unusually stable cash flows
   - Modest revenue growth
   - Margin expansion
   - Sound capital allocation

3. Low risk turnarounds / Special situations
   - Quality core
   - Requires strategic review or new management
   - Divestment of non core assets
   - Spin offs

High quality growth & stable compounders



Low risk turnarounds



Typical portfolio positioning

High Quality Growth 40%

AutoTrader
rightmove
Softcat
MSCI
ANSYS
Verisk

Stable Compounders 40%

CONSTELLATION SOFTWARE INC.
GEBERIT
CRODA
Copart
McCormick
VERISIGN

Turnarounds / Special Situations 10%

KAR AUCTION SERVICES
Domino's
Cerner

Cash 10%

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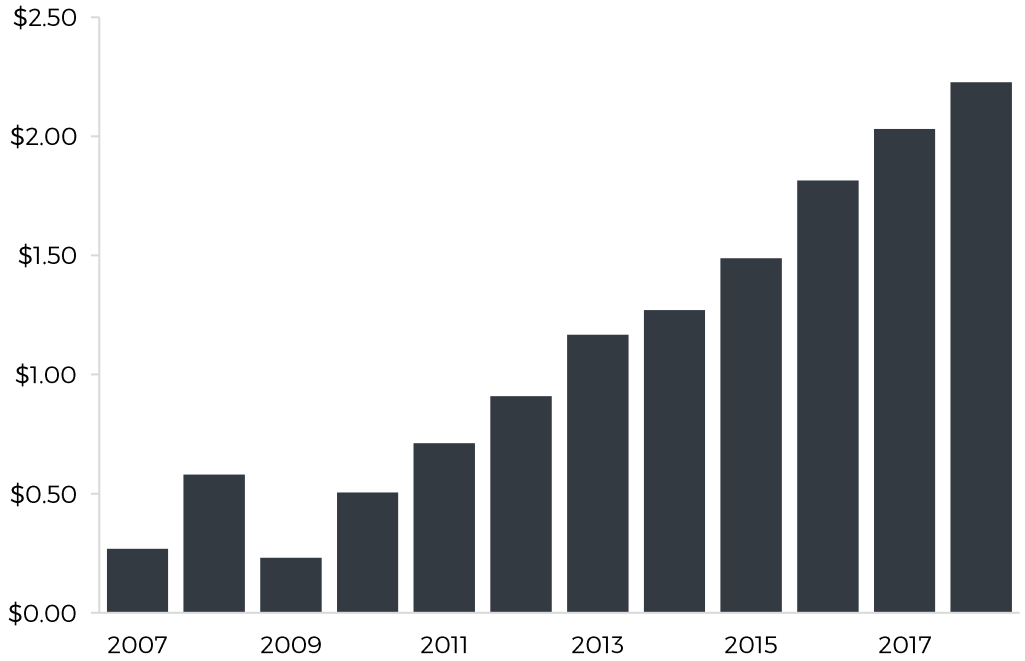
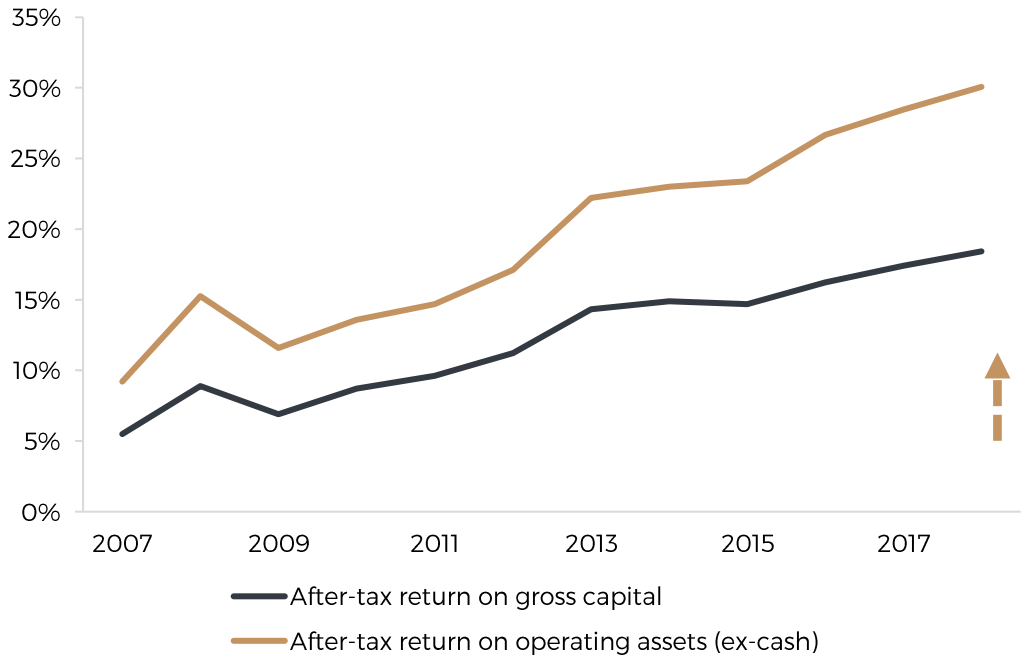
Techtronic Industries

Techtronic Industries

Earnings per Share



Returns



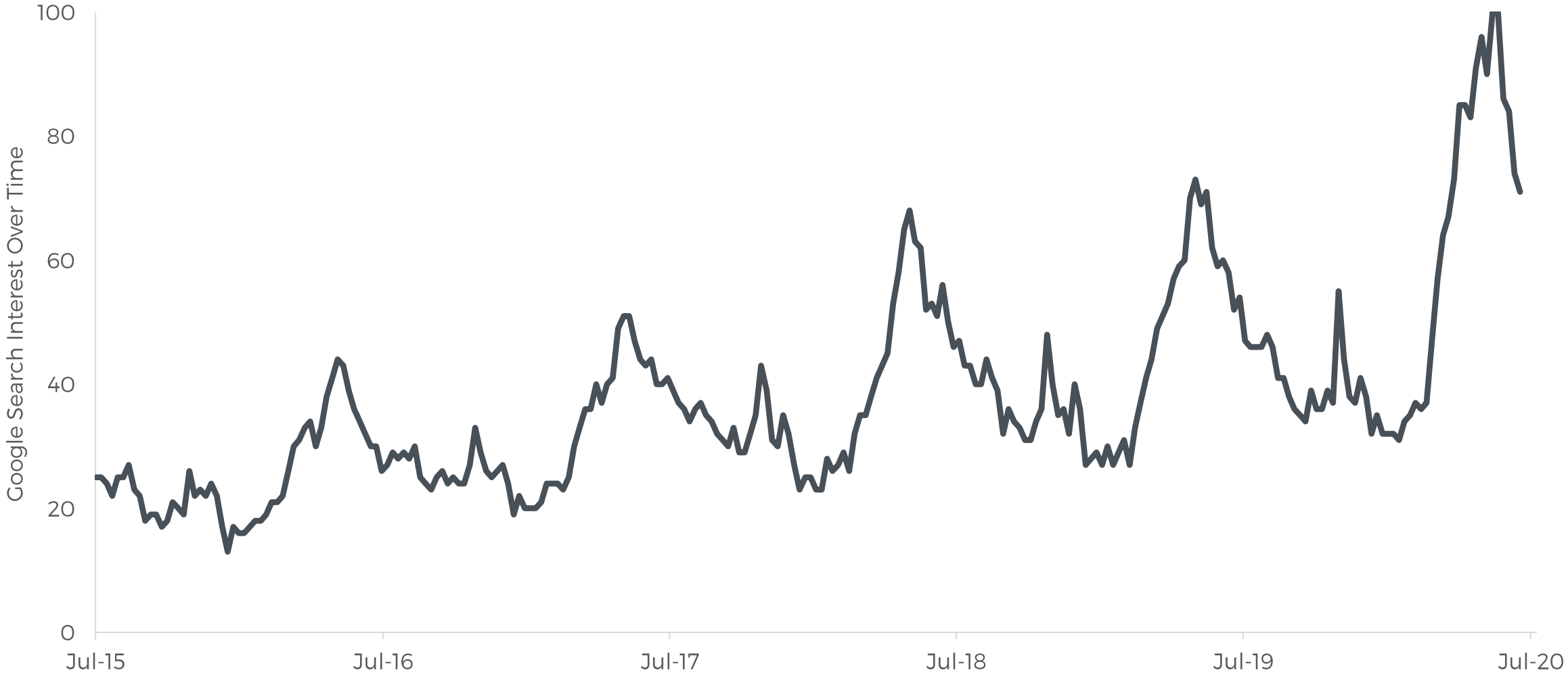
Industry leader:
World-class leader in design, manufacturing and marketing of premium power tools

Strong brand value:
Owner of the best brands in the industry including Milwaukee (professionals) and Ryobi (DIY home-improvers)

Innovation track record:
Innovative products result in market share gains and strong organic growth (10% CAGR over 10 years)

Highly aligned:
High insider ownership (founder retains 20% stake) and a highly aligned and motivated management team

Techtronic Industries



Source: Google Trends

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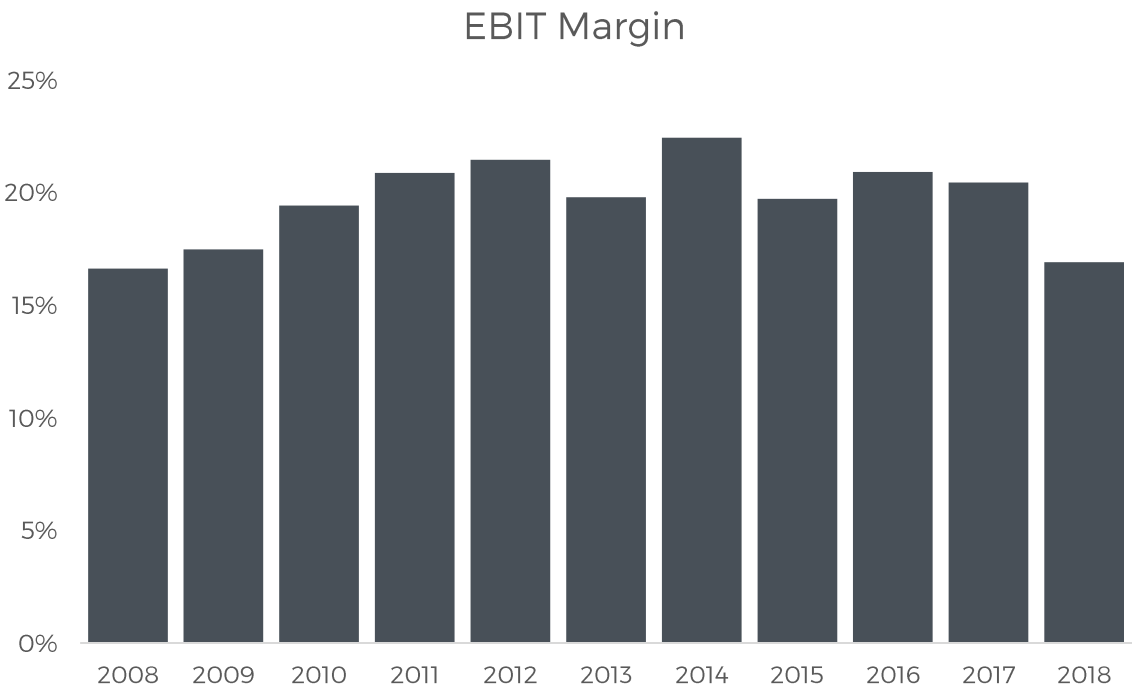
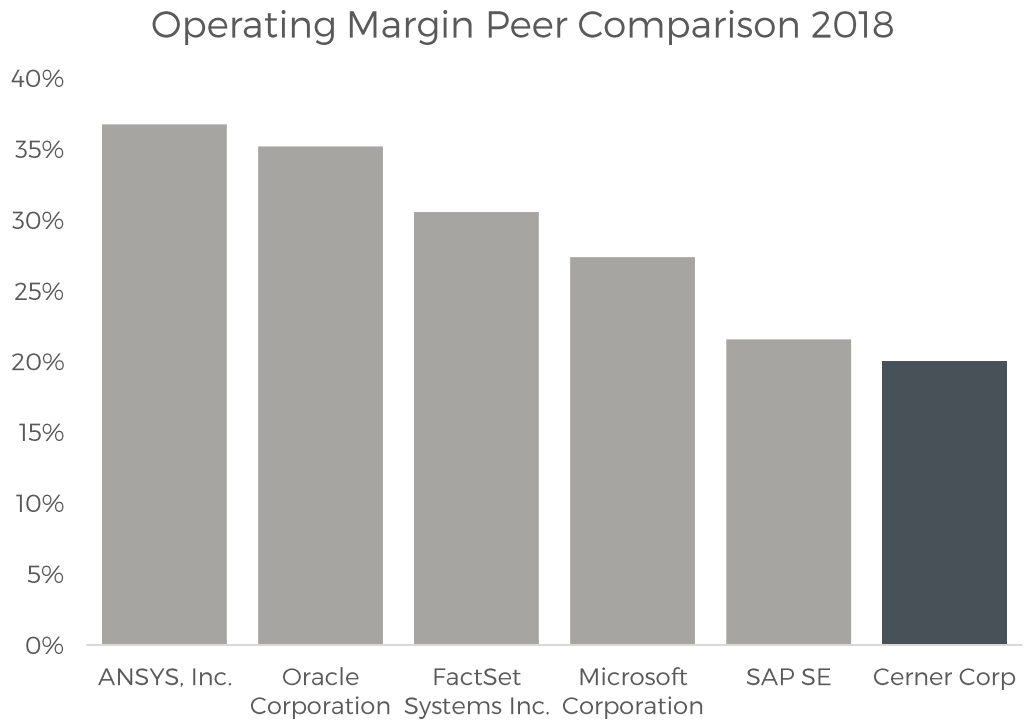
Cerner

Cerner





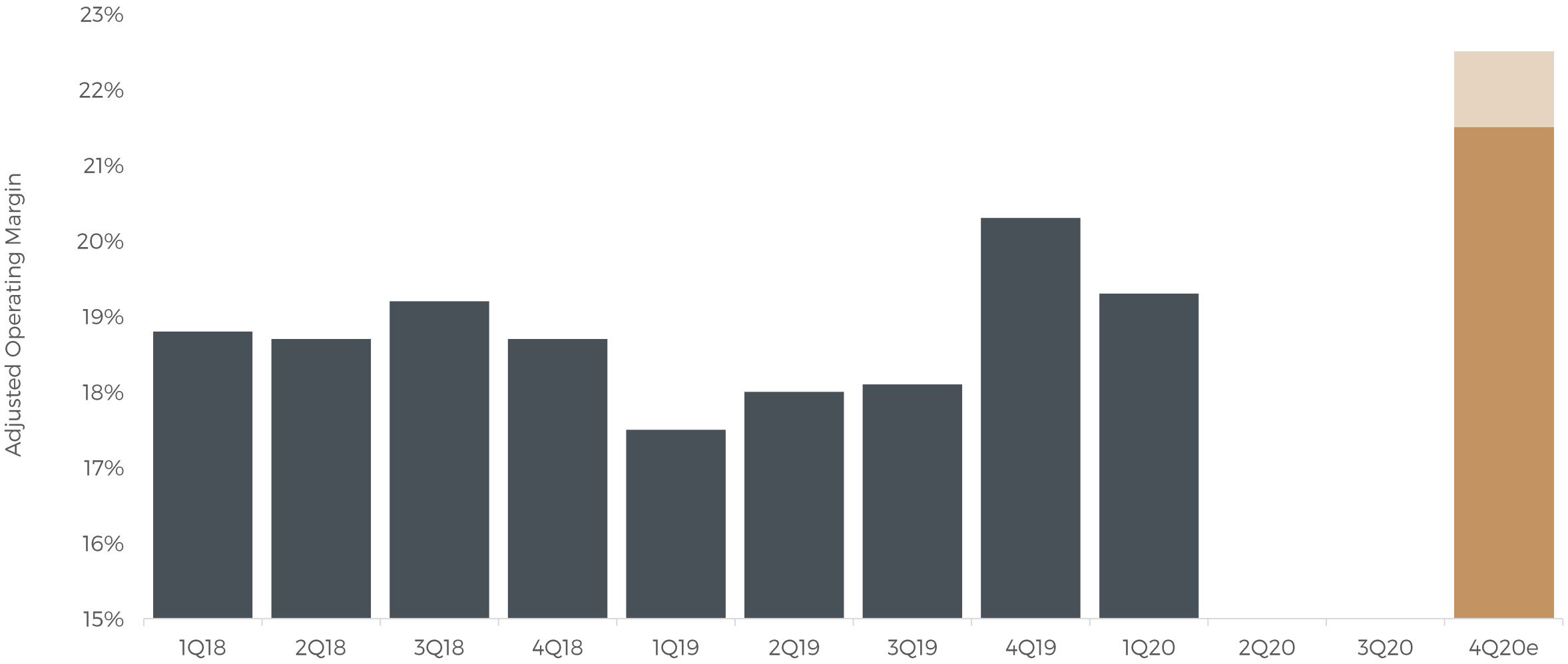
Consolidating market:
Cerner and EPIC combined win 80% of new tenders, HITECH Act hype gives way to realistic outlook

Increasing revenue quality:
Recurring and highly visible revenue now 88% of total

Margin pressure to abate:
R&D investment elevated ahead of population health opportunity

Expectations reset:
Withdrawal of the HITECH Act stimulus now well understood

Cerner



Source: Cerner company filings

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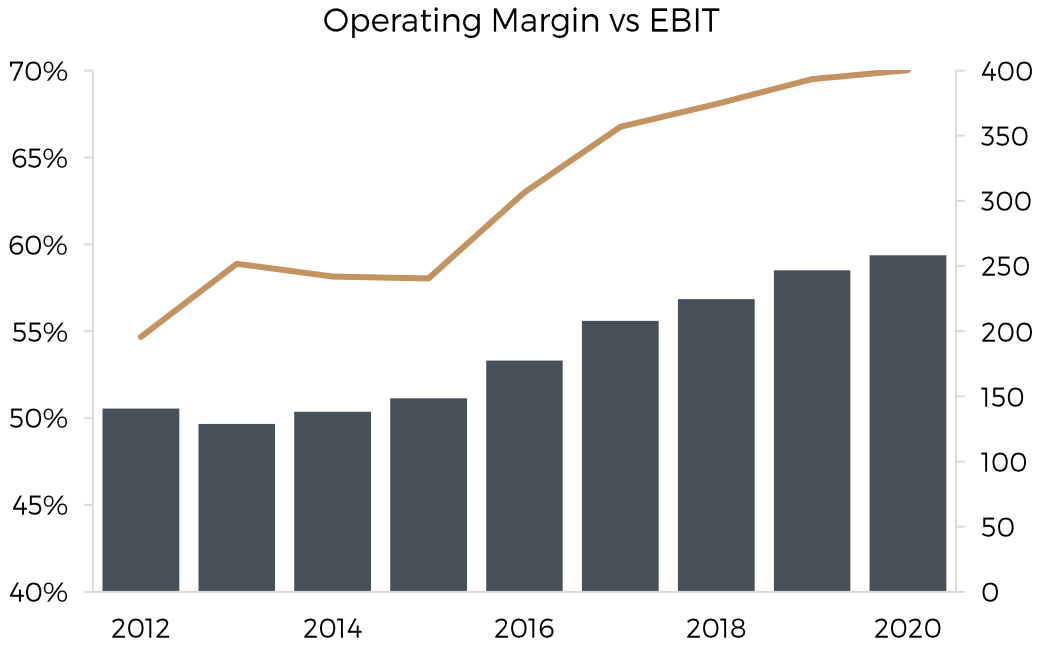
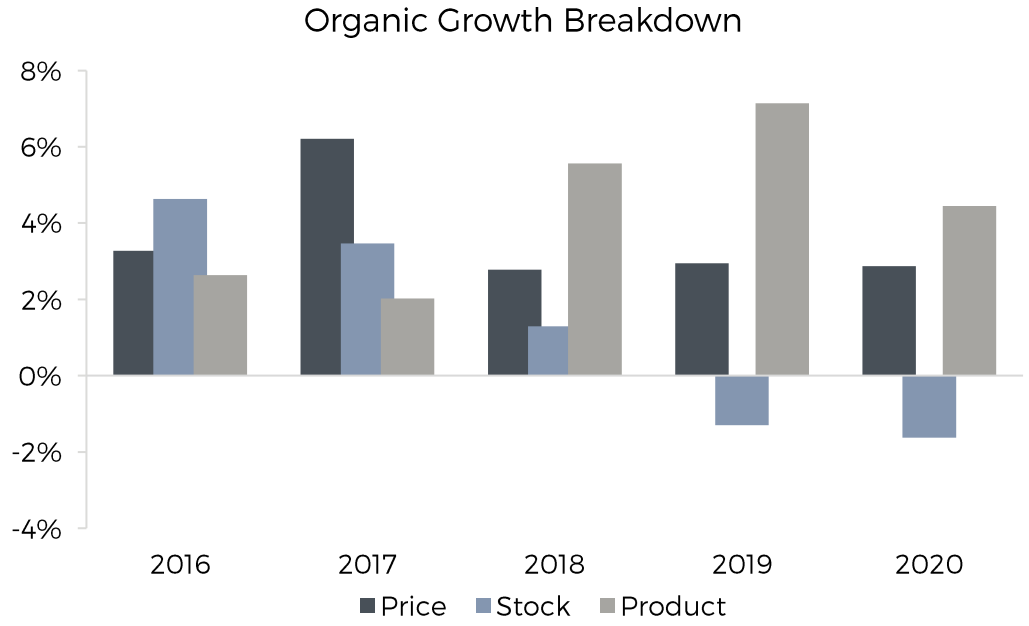
Auto Trader

Investment example – Auto Trader





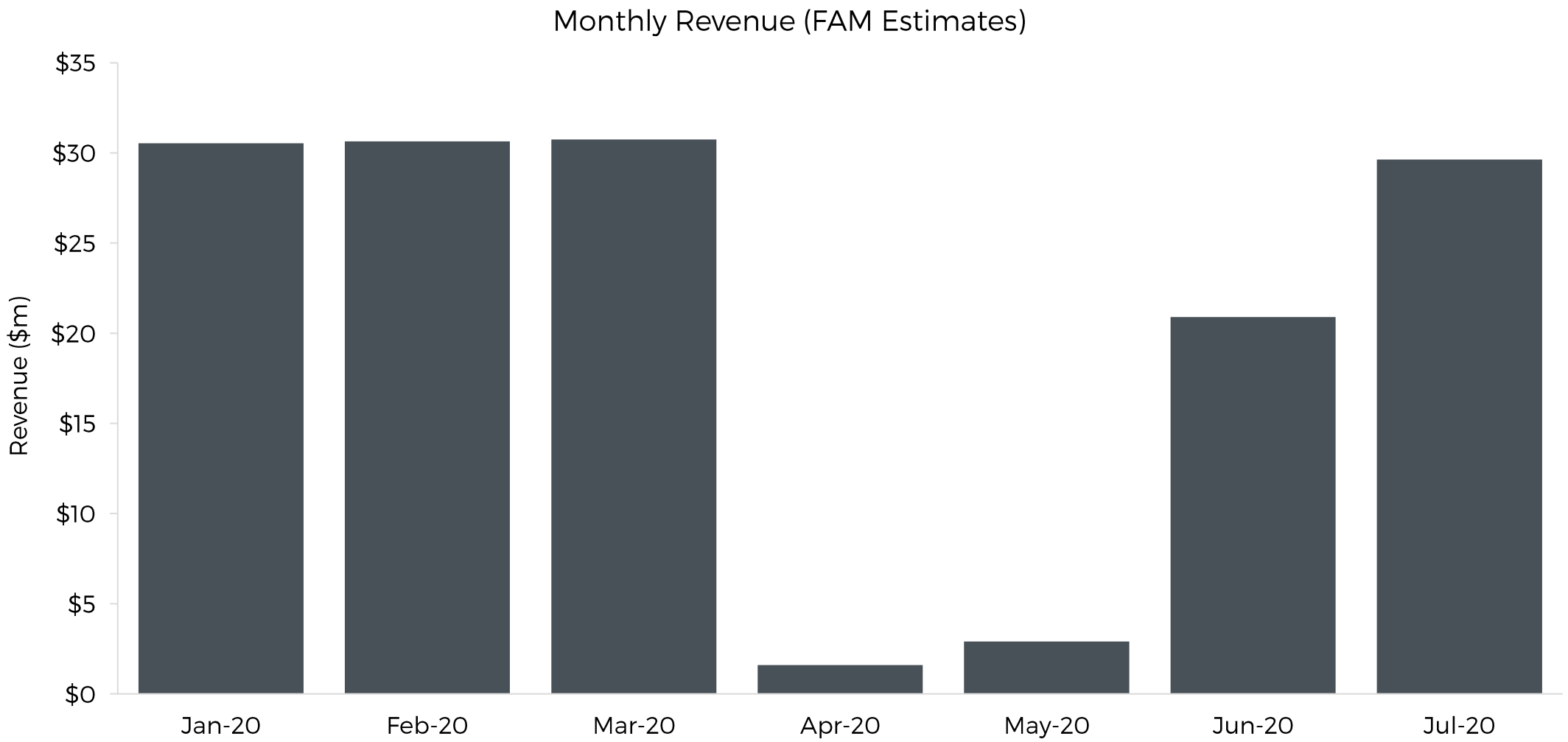
High quality classifieds:
Auto Trader is a 100% digital automotive marketplace, connecting buyers with predominantly used car retailers as well as manufacturers and C2C

Dominant market position:
Auto Trader has an audience 3x larger than its nearest competitor, 93% brand recognition and 80% of all retailers advertise on the site

Multiple growth levers:
Auto Trader has achieved a 9% p.a organic growth CAGR since 2014. This is through releasing new add-on products and price increases

Inherent operating leverage:
Since listing margins have expanded from 55% to 68%. Over the long term we expect expenses to increase lsd while revenues grow at msd or higher

Investment example – Auto Trader



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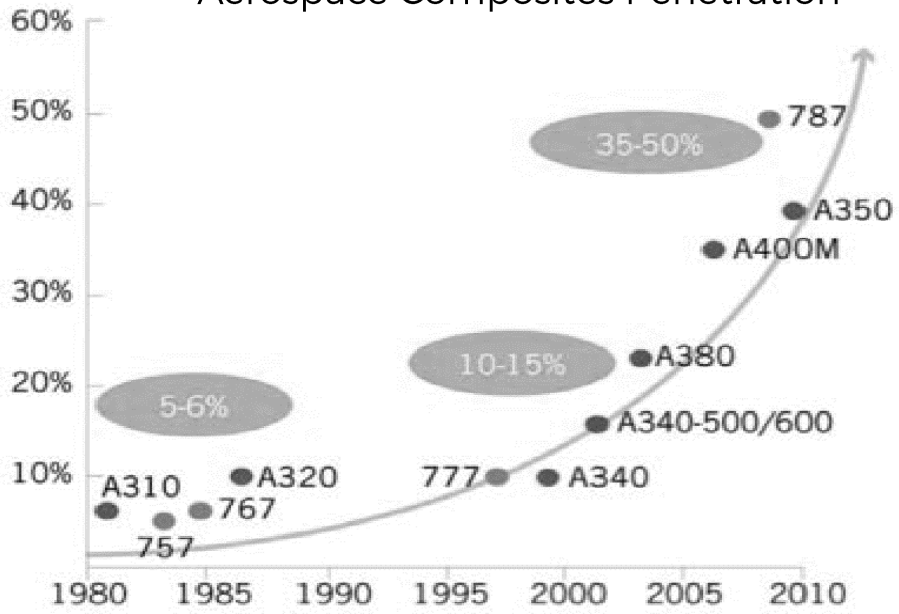
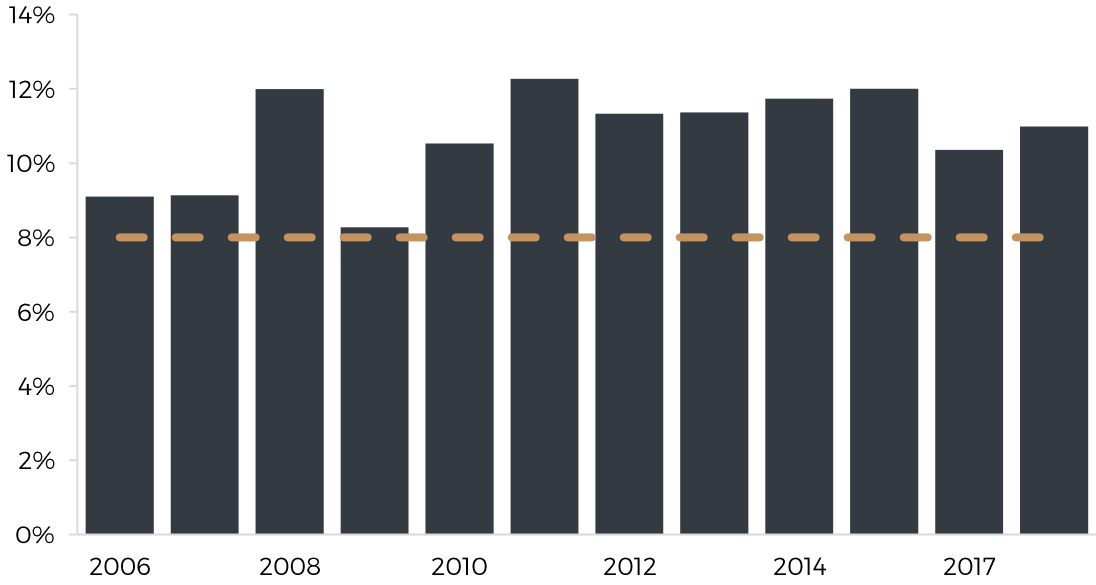
Hexcel

Hexcel

Aerospace Composites Penetration



Cash Return on Capital Invested (CROCI)



Sole supplier:
Hexcel is one of two companies in the world qualified to produce aerospace grade carbon fibre and is essentially the exclusive carbon fibre supplier to Airbus.

Structural growth tailwinds:
Continued growth in air traffic, the replacement cycle and increased penetration of composites combine to form a long runway for organic growth.

Capital intensive:
Manufacturing carbon fibre is a capital-intensive process. However, sunk capital serves as a barrier to entry and HXL earns pleasing returns.

Backlog provides durability:
Boeing and Airbus currently have a backlog of 13,000 planes, this backlog alone equates to 5 years of revenue for Hexcel.

Hexcel

Fairlight delivers letter to the Board of Hexcel Corporation highlighting concerns with Proposed Merger, including that it has limited strategic merit and significantly undervalues Hexcel, a demonstrably higher quality business.

28 January 2020

Fairlight
Asset Management

The Board of Directors
Hexcel Corporation
Two Stamford Plaza
281 Tresser Blvd, 16th Floor
Stamford, CT 06901
USA
Attn: Chairman, CEO and President Nick L. Stanage
Lead Independent Director Jeffrey C. Campbell

Dear Mr. Stanage, Mr. Campbell and Members of the Board:

I am writing to you on behalf of Fairlight Asset Management Pty Ltd ("Fairlight") and our clients who are collectively minority stockholders in Hexcel Corporation ("Hexcel" or the "Company").

Fairlight's investment philosophy is to build a portfolio of the highest quality businesses, as indicated by their high returns on capital, predictable revenues and conservative management teams that are responsible stewards of the business and shareholder capital. Businesses that boast these characteristics are rare, and when found, we strongly believe the optimal outcome for our clients is to hold onto them for the long term.

Occasionally, portfolio holdings are acquired away from us as other market participants recognize the same long-term value that we see and are willing to pay a premium today to control these businesses. Whilst we would generally prefer to maintain ownership in a high quality business forever, provided our clients are being appropriately compensated (remembering the rarity of such businesses), we are amenable to acquisitions. In the case of the proposed 'Merger of Equals' (the "Proposed Merger") between Hexcel and Woodward, Inc. ("Woodward"), we do not believe our clients nor any other Hexcel stockholders are being fairly compensated for losing their claim on the significant value Hexcel is poised to generate over the long term.

To be clear:

1. The terms of the Proposed Merger short-change Hexcel stockholders, who will be trading undervalued Hexcel shares for overvalued Woodward shares. Further, the quality of a standalone Hexcel will be diluted in the combined entity.

2. The Proposed Merger has limited strategic merit. The suggested revenue and product synergies are, in our view, specious and are unlikely to offset the poor transaction terms being forced on Hexcel stockholders. In terms of potential product integrations, we believe it is Hexcel who holds the desirable intellectual property, which in this arrangement is being relinquished to Woodward for free.

3. By agreeing to an onerous transaction break-up fee (4% of Hexcel's market capitalization), the Board of Directors of Hexcel (the "Board") has reduced the likelihood of an alternate bidder emerging and has seemingly pushed minority investors to accept the unfavorable Proposed Merger. That being said, Fairlight intends to vote against the Proposed Merger, given that we believe the value the Company will generate as a standalone business will far outweigh the potential break-up fee.

Hexcel - a demonstrably higher quality business

When compared to Woodward, we believe Hexcel has superior financial characteristics, organic growth profile and durability. Furthermore, the Company is comfortably ahead of Woodward when comparing the businesses across returns on capital, margins and balance sheet health. In addition, Hexcel has an enviable competitive position as the preferred carbon fibre supplier to Airbus and will enjoy a multi decade tailwind to organic growth as the increased penetration of composite materials continues. Even without any aftermarket exposure, the aeroplane construction backlog stretching years into the future gives Hexcel's revenues unappreciated visibility and durability. In the Proposed Merger, stockholders trade Hexcel's enviable financial characteristics for Woodward's inferior characteristics without adequate compensation.

Trading undervalued Hexcel shares for overvalued Woodward shares

We believe this Proposed Merger has been struck at a particularly inopportune time for the Company's stockholders, given Hexcel equity is trading at historical lows compared to Woodward's which is at historical highs. Over the past 10 years, Hexcel stock has traded at a premium over Woodward stock (measured as relative forward P/E multiples) 63% of the time. The average premium during this period has been 6% over Woodward equity. Given the superior quality of the Company's profile and outlook as discussed above, this is unsurprising.

However, when the terms of the Proposed Merger were struck, Hexcel was trading at an 11% discount to Woodward, a historical anomaly (Hexcel's current PE of 19.3x is below its 12 month average of 20.2x, conversely Woodward's current PE of 21.6x is above its 12 month average of 19.9x). If the Board had waited for valuations to return to historical spreads, Hexcel stockholders would have been better off by 17%, which we would contend still undervalues Hexcel equity, given it is Hexcel that is bringing the intellectual property that achieves the Proposed Merger's strategic imperative of product light weighting and enabling customer's emissions reduction.

The numbers above lend support to another common sense conclusion: Hexcel is currently trading under a cloud of uncertainty from the grounding of the 737 MAX, temporarily impacting the market valuation of the Company's equity. Further, Hexcel is exiting a multi-year period of significant investment in its manufacturing capacity, and we expect the business to reap increased cash flow and earnings from these investments over the next 2-3 years, which is not fully reflected in the merger price.

Search for alternate bidder or renegotiate terms

Given the concerns outlined above, we urge the Board to take the following actions:

1. We believe Hexcel is a high quality business trading at an attractive valuation. The Board should search for an alternate bidder to encourage an open and competitive bidding process and ensure Hexcel stockholders are compensated via an appropriate takeover premium.

2. Without an alternate bidder, the Board should renegotiate terms with Woodward to reflect the historical premium Hexcel has traded at, its superior financial characteristics and competitive positioning.

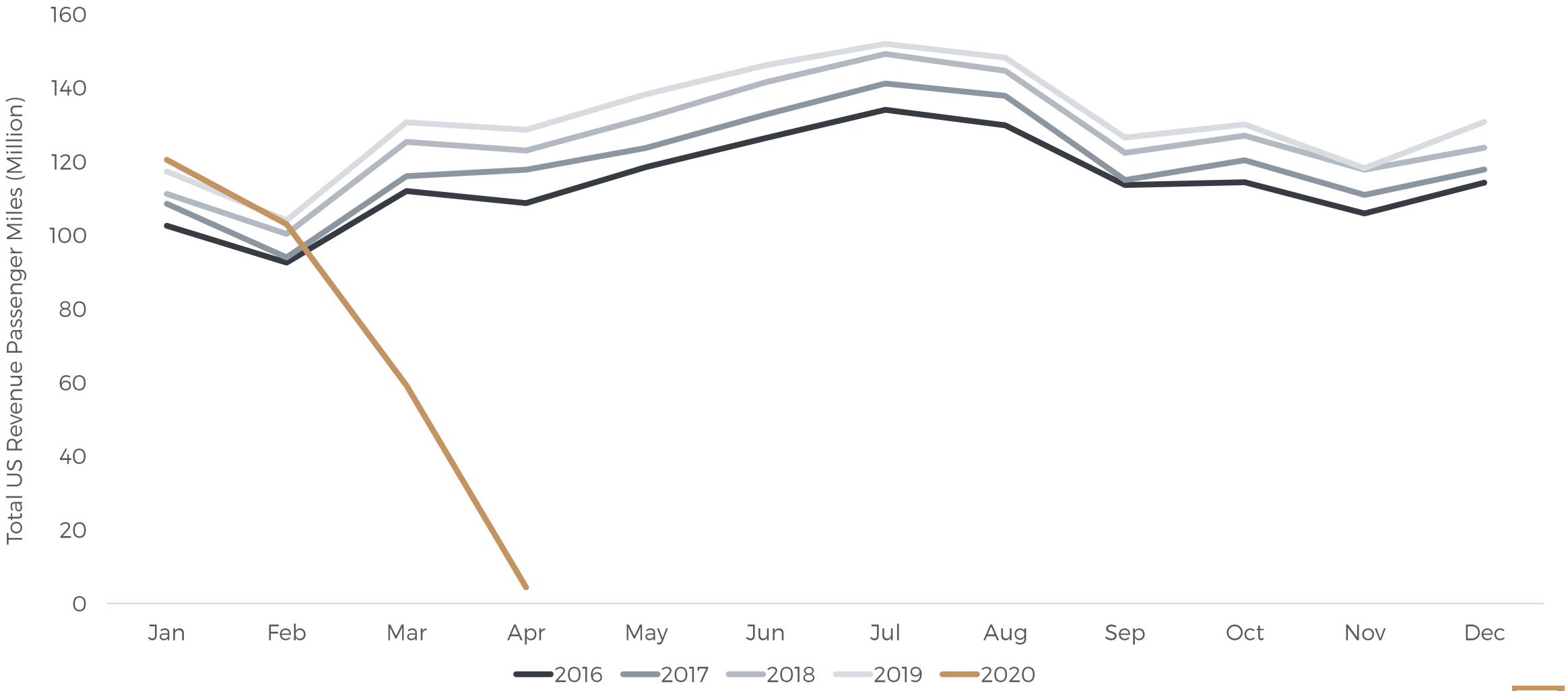
3. Failing the above, the Board should reconsider the merits of the Proposed Merger in its current form and return to executing on Hexcel's successful standalone strategy.

In light of the arguments outlined above, Fairlight will be voting against the Proposed Merger.

Regards,

WILL DOWD, CFA
Analyst | Partner
wdowd@fairlightam.com.au

Hexcel



Source: Bureau of Transportation Statistics

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