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February 12, 2025

GABELLI FUNDS

Happy Valentine's Day!

Company	Ticker		Price	Exchange
Astronics	(ATRO	-	$18.52 -	NASDAQ)
Ducommun	(DCO	-	64.59 -	NYSE)
Innovative Solutions & Support	(ISSC	-	11.14 -	NASDAQ)
Mercury Systems	(MRCY	-	46.28 -	")

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-Please Refer To Important Disclosures On The Last Page Of This Report-

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Small Cap A&D Consolidation

Over the last three years, there has been significant consolidation in the aerospace and defense industry from both strategic and private equity buyers. Notable deals include L3Harris' acquisition of Aerojet Rocketdyne, KKR and Circor, Arcline and Kaman, Apollo and Barnes Group, and most recently Warburg Pincus/Berkshire Partners with the announced merger of Triumph Group. The acquisition spree has driven up industry multiples and left only a few small cap aerospace and defense companies remaining. In our opinion, the push for consolidation is driven by three forces. First, the commercial aerospace industry has a decade long backlog and travel demand remains strong, this bodes well for both OEM sales and the aftermarket. Second, regulation for the aerospace industry, which is enforced by the FAA, is strict and presents high barriers to entry. In many cases, there is only one provider of a given component. Lastly, acquirers are able to drive strong synergies post-acquisition. For instance, larger companies are able to implement a more aggressive pricing strategy, which carries high incremental margins. Below we highlight the terms from the marquee deals in the industry over the last few years.

Table 1 **Recent Aerospace & Defense Acquisitions**

Acquirer	**Target**	**Year**	**Deal Size (USD, Bn)**	**Multiple (EBITDA)**
Triumph Group	Warburg Pincus/Berkshire Partners	2025	$3.0	15.2 x
Kaman	Arcline Investment Management	2024	1.8	14.6
Spirit Aerosystems	Boeing	"	8.3	9.2
Heroux Devtek	Platinum Equity	"	1.0	10.3
Barnes Group	Apollo Group	"	3.6	10.6
Aerojet RocketDyne	L3Harris Technologies	2023	4.7	12
Circor	KKR	"	1.6	10.6
Meggitt	Parker Hannifin	2022	8.2	24.5
Average			**$4.0**	**13.4 x**

Source: Company Press Releases, Gabelli Funds Estimates

Investment Opportunities

In our opinion, the four most attractive companies are: Astronics, Ducommun, Mercury Systems, and Innovative Solutions & Support. A major theme amongst these companies is the ownership of long-term contracts with large OEMs, such as Boeing, Airbus, Lockheed Martin and Textron. This provides a clear line of sight on future cash flows. Additionally, these companies have significant intellectual property, which provides another barrier to entry. Below, we review each company and analyze the potential for an acquisition.

Table 2 **Potential Acquisition Candidates (In Order of Likelihood)**

Company	**Price**	**Mkt. Cap**	**TEV**	**2026 EV/EBITDA**	**Potential Acquiror**	**PMV**
Mercury Systems	$46.28	$2,740	$3,150	16.3x	LMT, LHX, PE	$60
Ducommun	$64.59	950	1,200	7.9	PE	90
Innovative Solutions & Support	$11.14	191	219	11.2	HEI, PE	14
Astronics	$18.52	650	845	5.7	TDG, TXT, PE	40
Average		**$1,133**	**$1,354**	**10.3x**		

Source: Company Filings, Gabelli Funds Estimates

Mercury Systems

For the last year, Mercury had been plagued by idiosyncratic issues brought on by the overly aggressive prior management team. We think highly of new CEO Bill Ballhaus, who is an aerospace veteran and was appointed by JANA Partners. It should be noted this hedge fund has a history of putting companies up for sale, such as Whole Foods to Amazon and Frontier Communications to Verizon. Mercury was plagued by ~20 problematic classified programs that used the same technology architecture. This led to increased losses, higher working capital and ultimately significant free cash flow burn. In our opinion, the company reached an inflection point two quarters ago, whereby it generated $61m of free cash flow. While the 2025 earnings will still be depressed, we estimate a recovery in 2026 to Mercury's record 2022, when it generated $200m of EBITDA. Given the company's critical role on hundreds of key defense platforms, 18x 2026 EBITDA seems plausible. This would yield a share price of close to $60 per share. We think the most logical buyers would be Lockheed Martin, L3Harris Technologies or private equity.

Ducommun

Ducommun has already received formal offers from private equity firm Albion River for $60 and $65 per share, but declined both. In our opinion, the offers significantly undervalue the company. Earnings are set to increase with ramping volumes and successful restructuring efforts. A price north of $90 per share seems more reasonable, which would value the company around 12x 2025 EBITDA of $130m. Longer term, we think there is significant upside if the company is able to implement its Vision 2027 plan. This would allow Ducommun to generate sales and EBITDA of $1bn and $200m, respectively. If you apply a peer multiple of 12x to $200m of EBITDA, DCO shares would be worth an astounding $150 per share. Lastly, CEO Steve Oswald has experience selling businesses. In 2015, he was the CEO of a KKR portfolio company called Capital Safety, which was acquired by 3M for $2.5bn. In short, we think management is waiting for earnings to return to peak levels in late 2025 or 2026 so they can sell Ducommun for a more attractive price.

Innovative Solutions & Support

Innovative Solutions & Support has demonstrated impressive growth following the successful integration of two Honeywell product lines. These acquisitions have allowed IS&S to enhance its portfolio of advanced avionics and flight control systems, helping to strengthen its competitive edge. With new management taking a more aggressive approach than the company's founder, ISSC is actively pursuing opportunities to expand its reach, streamline operations, and boost profitability. Given ISSC's recent trajectory and the alignment of its deals with those executed by serial aerospace acquiror, HEICO, we think ISSC has become increasingly attractive as an acquisition candidate. Therefore, we apply a 14x EBITDA multiple to our 2026 estimate of $19m, which would translate to a price of $14 per share.

Astronics

Astronics has been a victim of Boeing production issues. The company has enviable positions to provide in flight power and entertainment systems. Additionally, there is an attractive and rapidly growing aftermarket as older plans are retrofitted with new inflight entertainment technology. Recently, ATRO won the contract to provide over $1m in shipset content for the FLRAA program. It is estimated over 2,000 aircraft will be made over the duration of the program. We think as earnings normalize with production rates and the UK patent litigation case is closed, Astronics will trade closer to 10x EBITDA. TransDigm would also be an obvious candidate to acquire Astronics given the two companies compete against each other in many different avionic products. In our opinion, a price of $40 per share would not be unreasonable.

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