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Letter to investors, Q3 2024

Performance

As reported by our fund administrator, the Master Account, in which I am personally invested alongside SMA clients, returned 8.9% net in Q3 2024 vs 5.9% for the S&P500. As of Q3, 2024, the top ten positions comprised approximately 71% of the portfolio, and the portfolio held approximately 9% in cash.

	QTD	YTD	1-year	3-years	5-years	Inception
ACML	8.9%	13.5%	28.1%	3.0%	5.6%	7.2%
S&P500 TR	5.9%	22.1%	36.4%	11.9%	16.0%	17.5%

ACML performance is net of fees and standard costs.

Portfolio – top and bottom performers[1]

Top Performers	Contribution	Bottom Performers	Contribution
KKR & Co Inc	2.53%	Cirata Plc	-0.66%
Brookfield Corporation	1.46%	Melrose Industries Plc	-0.46%
Prosus NV	1.31%	Alphabet Inc	-0.40%
Fairfax Financial Holdings Ltd	1.20%	Oaktree Specialty Lending Corp	-0.29%
Cogent Communications Holdings Inc	0.94%	Amazon.com Inc	-0.19%

As calculated by our fund administrator on the Master Account.

KKR & Co Inc

KKR continues to deliver strong performance this year. The company has reported an uptick in capital markets activity, which had previously slowed, leading to increased fees from transactions and the potential for more realizations and carried interest as M&A activity resumes.

Additionally, KKR has entered a new fundraising cycle, recently securing a $10 billion first close on its Infrastructure V fund. In recent years, KKR has strategically emphasized infrastructure, credit, and real estate, with its core flagship strategies representing only 6% of total AUM fundraising. Now, the company is refocusing efforts on raising capital for its flagship North American and Asian buyout funds, positioning itself for continued growth in earnings and carried interest moving forward.

[1] There is no assurance that any of the securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable. See "Disclaimers" at the end for more details.

Brookfield Corp
Brookfield delivered a strong presentation during its capital markets day, setting ambitious goals for the years ahead. The company aims to achieve a 17% compound annual growth in distributable earnings per share from 2024 to 2029 and generate $45bn in cashflows over that period. Of which $24bn will be "excess cashflows" after dividends and reinvestment, which can be used for share repurchases.

A key focus of Brookfield's strategy is its wealth management business, where it aims to grow AUM from $110 billion to $300 billion by expanding in the U.S. and entering European pension markets and Japanese annuities. Brookfield believes it can leverage its investment expertise to offer consumers 4-5% returns while maintaining a consistent spread through its diverse investment opportunities. Although there is a risk that spreads could compress in a declining interest rate environment, Brookfield is confident that its investment acumen and deal flow will support sustained healthy returns, targeting 15-20% ROEs.

Regarding real estate, which has been a significant challenge since the pandemic-driven shift to remote work, the company reaffirmed that performance remains strong within its high-quality core portfolio and plans to move its $15 billion in core assets into its insurance and wealth management accounts, providing a better home for long-term, stable cash flows. At the same time, the company intends to sell $7 billion of its $8 billion in "transition and development" properties to reinvest in other opportunities.

Brookfield's recent appointment of 36-year-old Connor Teskey, a rising star and current head of Brookfield Asset Management, as future CEO, alongside Bruce Flatt's eventual transition to Chairman, mirrors KKR's smooth leadership change in 2021. By grooming internal talent, Brookfield signals its commitment to long-term sustainability and a strong corporate culture, setting the stage for continued compounding in line with its five-year plan.

Prosus NV
Prosus' new CEO, who assumed the role in July, is focused on improving the company's operational performance. With his background at iFood and given that food delivery accounts for one-third of Prosus' non-listed assets—including stakes in Delivery Hero and Swiggy—some analysts speculate that Prosus may pursue mergers and acquisitions in European food delivery. A potential combination of iFood, Delivery Hero, and JustEatTakeaway, for instance, could generate over $300 million in annual cost savings and pave the way for a spin-off or other strategic actions, in line with management's long-term goal of unlocking value beyond its Tencent holdings.

In the meantime, Prosus' share price has benefited from China's recent comprehensive stimulus package, which sparked a rally in Chinese equities. Key measures included a 20-basis point cut to the seven-day reverse repo rate to 1.5%, a 0.5% reduction in the reserve requirement ratio for banks, injecting 1 trillion yuan into the financial system, as well as mortgage rate cuts and lower down payment ratios for second homes. China also provided 500 billion yuan in liquidity support to stabilize its stock market. While the long-term effects of these measures are uncertain, I hope this event demonstrates the potential rewards of patiently holding onto undervalued quality assets, even when it's difficult to predict the exact catalyst for a share price re-rating.

Fairfax Financial Holdings Ltd
Fairfax Financial Holdings continues to demonstrate the ability to generate robust returns from thriving insurance operations and a disciplined investment approach. Fairfax's insurance operations reported solid underwriting performance, with a combined ratio of 93.9% and positive reserving. It now consolidates Gulf Insurance, which it acquired earlier in the year, and which helped grow net written premiums by 11.5% (3% ex-Gulf). The company has hinted that it has significant opportunities for international growth in insurance.

Peter Clarke, President and COO, remarked during the last earnings call, "We've never had this kind of visibility on the investment side, and it puts Fairfax in an excellent position from an earnings and a capital perspective for the next few years." The investment portfolio currently stands at $66 billion, of which $37 billion is in fixed income,

$9 billion in cash and short-term investments, and $20 billion in equities. As the company has evolved in recent years, more of its performance is now driven by insurance and private businesses, with less reliance on fluctuations in marketable securities. Fairfax reiterated its expectation of achieving $4 billion in operating income, derived from interest and dividends, underwriting profits, and contributions from its non-insurance associates. Notable transactions included the $862 million acquisition of Sleep Country Holdings and the sale of Stelco shares to Cleveland-Cliffs, resulting in a $390 million gain. Fairfax also continued its share repurchase program, spending $678 million in the quarter, underscoring management's belief that its shares remain undervalued despite trading above reported book value.

Cogent Communications Holdings Inc

In its latest earnings release, Cogent reported steady, albeit unspectacular, performance in its core operations. There has been some progress on extracting cost synergies from the Sprint acquisition, and there is some potential for value creation through monetizing "hidden assets" from its IPv4 and data center co-location fees. The company has made progress in realizing cost synergies from the spring acquisition and may unlock additional value by monetizing "hidden assets" such as its IPv4 holdings and data center co-location fees. However, the crux of the investment thesis remains the potential for significant revenue growth from waves. Without this catalyst, I believe the stock could drop to the low $60s, but with waves revenues materializing, the upside potential could exceed $150.

It is interesting to see what happened with Lumen, a competitor to Cogent, after announcing a $5 billion deal to build a custom network for Microsoft's data centers on July 24th. The stock jumped from around $1.50 to approximately $7 per share. From my understanding and based on reading a short seller report,[2] Lumen is primarily acting as a contractor in this deal, and it is estimated to retain only $800 million in one-time profits from construction and only $21 million in recurring profits.

In contrast, Cogent has the potential to generate over $500 million in recurring operating profits[3] if it can successfully sell its wave revenues over the next few years. The capital expenditure is much more limited, as Cogent is connecting an existing infrastructure that all its customers can use instead of a bespoke construction for just one customer. While I don't expect the same dramatic market reaction as Lumen's, Lumen's stock rally was partly due to relief from its potential bankruptcy risk as the influx of cash will help manage its substantial $18 billion debt; I do think this situation reflects the market's appetite for companies providing infrastructure critical to AI and cloud development.

Cirata Plc

Cirata recently faced a setback with the departure of its CFO, who joined the company in April 2023 as part of the turnaround management team. The CFO left for a role at another private company. This departure further underscores that turning the company around has been more challenging than new management expected.

One significant issue hindering Cirata's progress is its underdeveloped sales and marketing infrastructure, and the complex nature of larger enterprise sales. Despite the substantial untapped potential for data migration services amidst the growing cloud computing investments, Cirata has struggled to capitalize on these opportunities and announced some deal slippage in its first-half results. The company still believes it can hit its targets and close deals in the second half of the year. On September 30th, Cirata announced the renewal of its contract with Health Care Service Corporation (HCSC) for its Fusion product. This renewal, valued at $983,010, provided a glimmer of hope and contributed to a rally in the stock price. Nevertheless, more such contracts are urgently needed to demonstrate the company's ability to ramp up sales effectively. As previously communicated, I will give Cirata until the end of the year to achieve tangible sales growth, or I will cut it from the portfolio.

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[2] Kerrisdale Capital August 2024 report, available on their website

[3] Cogent management's estimate of the addressable TAM of $2bn x management's expectation of a 25% share @ 90%+ gross margins.

Alphabet Inc

Alphabet's solid quarterly performance, with revenue growth of 14% and improved margins improving from 29% to 32%, has been overshadowed by ongoing investor concerns regarding future capital expenditures for AI and antitrust risks.

In August, a federal judge ruled that Google illegally monopolized the search and advertising markets in the United States by using exclusive agreements with browser developers, smartphone makers, and wireless carriers. A second trial is scheduled for 2025 to determine enforcement remedies, with a final decision not likely before 2026, given the strong likelihood of Alphabet appealing any decision. Potential remedies may include making search engine data available to competitors and ending agreements to secure its search engine as a default on mobile devices. For example, Alphabet currently pays $20 billion annually for Google to be the default search engine on Apple products. Although regulatory challenges are never positive, Google's strong brand and consumer preference have limited the impact of previous restrictions. In Europe, Russia, and Turkey, Google search market share declined by only 2%, 7%, and 12%, respectively, when regulators limited its use as the default option.

Another trial focuses on Alphabet's Ad Tech platform, where the DOJ alleges that the company has monopolized the digital advertising market. Closing arguments are expected in the coming weeks, and a ruling against Alphabet could undermine Google's dominance in the online advertising ecosystem. Additionally, after the end of the quarter, Alphabet was ordered to open its Android operating system to rivals, allowing them to establish their own app marketplaces and payment systems to compete with Google Play Store. This followed a loss to Epic Games, the developer behind Fortnite, in a December ruling last year.

I will continue to monitor these developments and respond accordingly.

Melrose Industries Plc

I have initiated a new position in Melrose Industries. As with many of my new investments, I tend to enter positions when companies are facing temporary headwinds that create opportunities for attractive valuations. While it's impossible to perfectly time the bottom, I believe the long-term outlook for Melrose is promising. I have included a summary write-up at the end of this letter.

Oaktree Specialty Lending Corp

OCSL experienced a challenging quarter, with three additions to its non-accrual portfolio. The most concerning investment is Pluralsight, a provider of tech skills development services. Despite appointing a new CEO to address performance issues in April, OCSL has written down the investment by 50%. The other two non-accrual investments, AT Holdings and Dialyze, are primarily related to PIK interest and warrants acquired at a low cost. OCSL remains confident in recovering these investments. As part of the Oaktree family, OCSL benefits from a robust platform and a deep bench of expertise to manage its non-accrual investments.

The declining interest rate environment poses a potential threat to net interest margin. To mitigate this impact and support the dividend, the company voluntarily waived $3.2 million in incentive management fees, resulting in a $0.01 per-share increase in net interest income. While not ideal, this action demonstrates management's commitment to preserving shareholder value. At the current share price, OCSL now pays a dividend yield of over 13%, mainly from first lien credits.

Amazon.com Inc

Amazon's continued growth is driven by its strong performance in AWS and advertising, which grew 19% and 20%, respectively. E-commerce growth moderated to 9.3%, likely due to softer consumer demand.

In previous letters, I mentioned how Amazon's heavy investments in logistics and fulfillment suppressed margins for some time, but the company is now reaping the rewards of those earlier expenditures. European operations have been profitable for the second consecutive quarter, while North American operating margins have risen from pandemic lows to 5.3%. A key ongoing area of focus for Amazon has been reducing the "cost to serve"; this is beginning to show tangible benefits. In 2023, Amazon undertook a "regionalization" strategy, which divided the U.S. into eight distinct regions for fulfillment and transportation, with corresponding distribution centers in each. As I learned from an expert interview done by InPractise, "regionalization" has resulted in estimated shipping expenses dropping from $4.76 per unit to $4.50, and they are now approximately $4.26, with potential reductions of 2-3% annually. Interestingly, Amazon leaned on its third-party vendors (3P) to finance much of this strategy. It did so by requiring 3P vendors ship inventory to the multiple regional distribution centers, instead of to a single location as they used to do. Moreover, Amazon imposed penalties for failing to meet strict minimum and maximum quantities. In this way, Amazon used 3P inventory to expand its distribution capacity by around 24 million square feet, much of which it could use for its own 1P inventory. Clever strategy, but one wonders if this raises the risk of an eventual vendor backlash due to the added financial and logistical pressures on 3P sellers.

Like Alphabet, Amazon is investing heavily in its AWS infrastructure to support its growing AI business. In the first half of the year, the company spent $30.5 billion on capital expenditures, with plans to exceed that in the year's second half. When questioned about this during the earnings call, CEO Andy Jassy emphasized that they are seeing significant demand for AI-related services, which he believes will become a "very large" business for Amazon.

Trades

I trimmed KKR and Fairfax during the quarter as part of position sizing discipline. I also trimmed a little Prosus (unfortunately just before the surprise stimulus induced run-up in share price). I redeployed some funds to Alphabet, Brookfield Corp, Distribution Solutions, and Terravest, which were all smaller positions in the portfolio, and reported what I believed were good earnings. We still have approximately 10% of the portfolio in cash, which, while a drag on returns in an upmarket, allows for flexibility should one of our positions (or any new opportunity) become attractively priced.

Samer Hakoura
Alphyn Capital Management, LLC
October 2024

Melrose Industries Plc

Brief history

Melrose was previously a publicly listed private equity firm with a strong track record of buying, fixing, and selling companies. From May 2005 to December 2023, it generated a 20% average annual return on equity investment.

In 2018, Melrose acquired GKN for £8.1bn in a hostile takeover, an industrial conglomerate with metallurgy, automotive, and aerospace divisions. At the time, GKN had £10 billion in revenues and only 6.5% margins. Over the next few years, Melrose embarked on a massive restructuring plan, shedding all but the aerospace division (at the time £3bn in revenues), which management described as the highest quality company they have come across. Melrose is now simply a holding company for GKN Aerospace. In 2024, the co-founders of Melrose retired (albeit with eye-popping payouts) and promoted former Melrose COO Peter Dilnot, an engineer by training, an 8-year veteran of the British Military, and a 7-year veteran of Danaher, to become CEO of the new group.

Melrose Industries trades on the London Stock Exchange under the ticker MRO.LN. Its current market cap is £5.9bn, and its net debt is £1.24bn.

GKN Aerospace Divisions

GKN has two divisions: Engines (~35% of group sales and ~80% of group profits) and Structures.

GKN Aerospace summary financial

£m	*H1* 2024	2025 guide
Engines		
Revenue	720	1,700
Operating Profit	212	500
Margin	29.4%	29.4%
Structures		
Revenue	1,022	2,100
Operating Profit	48	200
Margin	4.7%	9.5%
Total Aerospace		
Revenue	1,742	3,800
Operating Profit	260	700
Margin	14.9%	18%

Source: Melrose half year results August 1, 2024

In the structures business, 67% of sales are civil, and 33% defense. Melrose sells wing structures, fuselages, empennages, and electrical wiring interconnection systems for narrow-body aircraft such as the Airbus A220 and A320 families and the Boeing 737. It also supplies advanced composites and metallic structures to major wide-body platforms, including the Airbus A330 and A350XWB and the Boeing 777 and 787 platforms. In defense, it supplies the F-35 fighter jet and Chinook, Apache, and NH90 helicopters.

Melrose has undertaken significant restructuring in this division (e.g., restructuring costs were £110m in 2023), reducing the number of sites from 40 in 2018 to 24 today and repricing specific defense contracts. Some benefits have included a cost-efficient footprint, a 75% reduction in manufacturing defects, and a 33% reduction in scrap as a percentage of sales. As a result of these initiatives, Melrose expects to double its operating margins by 9.5%.

The Engines division is the crown jewel of the business. 74% of its sales are civil, 26% defense. It manufactures parts such as turbine cases, fan cases, engine mount structures, and shafts. It has an advantaged position in engines, where it is a Super-Tier 1 supplier to all the major engine manufacturers GE, Pratt & Whitney, Safran, and Rolls Royce. As a result, GKN engine parts are on 90% of engines currently flying and all narrow-body aircraft. 70% of engine revenues are sole-supplier.

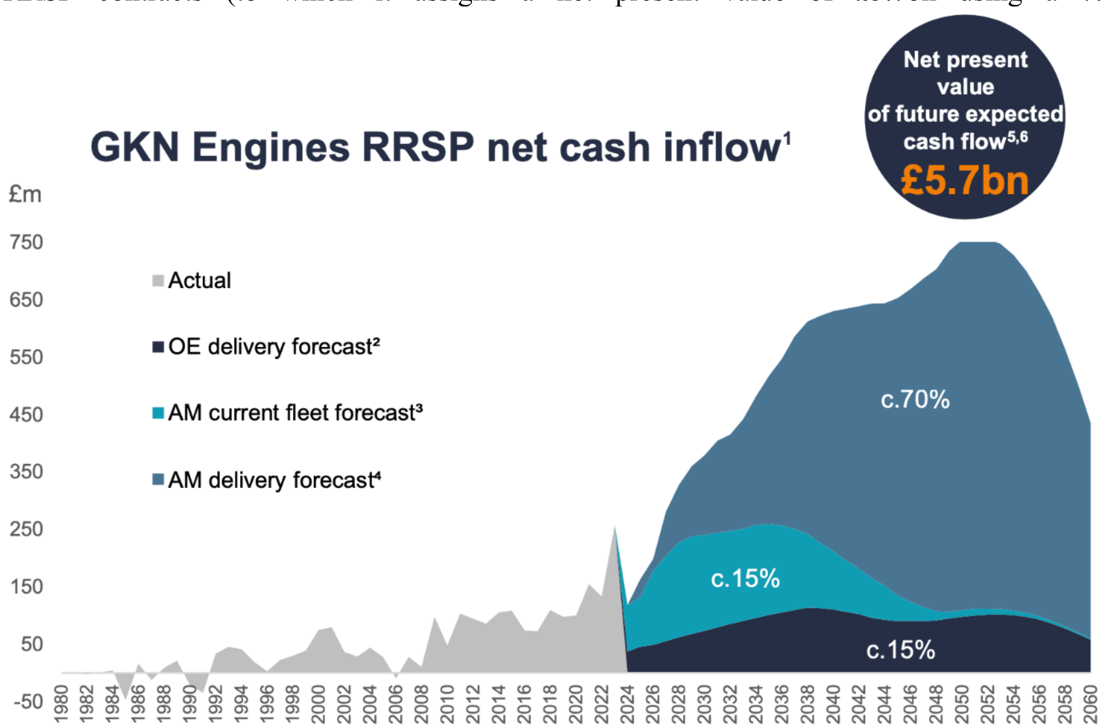
It is worth briefly summarizing the engine development cycle and how this plays into GKN's advantage.

It costs billions of dollars over decades to design and manufacture new engines. Once an engine platform is established, replacing it takes decades and billions of dollars. Therefore, once in production, engines have a long useful life of a few decades. They are subject to stringent mandated maintenance protocols at different hourly intervals (e.g. after 10,000 hours of use), and an engine will typically have three shop visits throughout its useful life. Most engine suppliers sell their engines at a loss and then make up their profits from aftermarket maintenance, which is their main profit driver and on which they have a high degree of visibility given the mandated maintenance requirements.

Super-Tier 1 suppliers like GKN are strategic partners for their OEM customers. They share in the development costs with design, validate, and build responsibility. As a result, GKN components are present on approximately 90% of all flight hours, 100% of narrow-body aircraft engines, and 70% of revenues are from privileged sole-supplier arrangements.

The most interesting part is the structure of revenue agreements with its Original Equipment (OE) customers. While 25% of revenues are from OE contracts, and 10% and 8%, respectively, are from Aftermarket sales from civil repairs and Government partnerships, 57% of revenues are from what are called Risk and Revenue Sharing Partnership (RRSP) agreements. Under these agreements, GKN shares in the costs of engine development with the Original Equipment Manufacturer (OEM). It generates revenues from the sale of OE components when the OEM makes engine sales (26% of total engine sales) but is also entitled to a lifetime share of aftermarket profits according to an agreed percentage (31 % of total engine sales). Due to GKN's focus on designing non-moving components like cases and mount structures, these parts typically do not require replacement throughout the engine's lifespan. Consequently, while GKN is entitled to a share of maintenance profits, it avoids the costs of supplying replacement parts or performing maintenance. This unique arrangement results in a high-margin royalty stream.

Melrose currently has a portfolio of 19 RRSPs covering 73% of global narrow-body flight hours and 68% of global wide-body flight hours. Over the next three decades, Melrose expects to receive £22bn in cash flows from these RRSP contracts (to which it assigns a net present value of £5.7bn using a 7.5% discount rate).



Source: Melrose half year results August 1, 2024

A couple of further details about the "cash mountain" depicted above from the RRSP portfolio: it includes approx. 29,000 older engines, such as the CFM56 and V2500, which have been in service since the early 1990s and are now generating substantial cash flow through regular maintenance. (engines in service on narrow-body aircraft) which came into service in the early 1990s. GKN has approximately 4,000 new engines, such as the Trent XWB-84K (used in widebody aircraft) and the P&W GTF series (newer engines used in narrow-body aircraft). These engines have only recently entered service (2015/6) and are still in the early stages of their maintenance cycles. Only 5-10% of these engines have had their first (of typically 3) shop visits. GKN expects to deliver approximately 19,000 more of these engines over the next 17 years, a source of significant future cash flow.

GKN's share of aftermarket profits varies depending on the engine type. For older engines like the CFM56, GKN's share is under 2%, while it will receive 4-7% for the P&W GTF series. This favorable revenue-sharing arrangement further enhances the company's cash flow profile. Furthermore, the £22 billion valuation only reflects the current value of engines in service. GKN's involvement in developing next-generation engines like the CFMI RISE and next-gen-GTF presents additional growth opportunities and potential future cash flow streams.

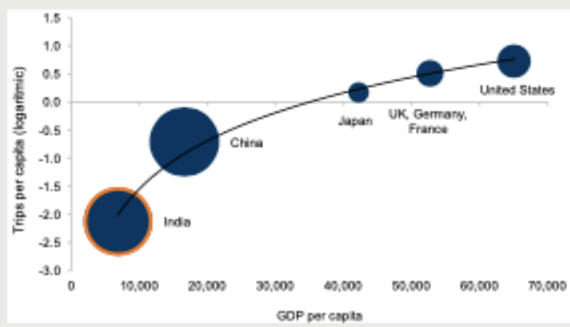
The macro backdrop is favorable

Long-term secular demand. Goldman Sachs estimates a market of 52,000 new aircraft in the next 20 years, or 2,700 new aircraft per year vs 1,243 delivered by Airbus and Boeing in 2019.

Air traffic has grown at 1.5x the rate of Global GDP, driving demand for new aircraft and maintenance. The industry is in the early stages of this growth, with many regions still having relatively low air travel rates. The average person in the U.S. takes two trips per year, compared to 0.5 in China and 0.1 in India.

Exhibit 11: Secular growth is driven by the growing global middle class, with higher incomes leading to a higher propensity to travel

GDP $ per capita and trips per capita by air (2019), bubble size represents population



Source: Airbus, World Bank, Goldman Sachs

Development of new fuel-efficient aircraft such as the 787, 737 Max, A320neo, A330neo, A350, and A220 creates an opportunity for fleet renewal, which will drive future OEM sales and subsequent aftermarket maintenance.

2) Supply pressures. The aerospace industry faces temporary challenges due to the pandemic, inflation, and supply chain issues. The industry relies heavily on skilled labor, has experienced workforce reductions during COVID, and is working to replace and train its new hires. Geopolitics have disrupted the supply of raw materials, such as titanium, from Russia, with companies working on reshoring. Inflation has impacted costs, with price normalization still ongoing, further exacerbated by strikes at Safran and Boeing. Well-publicized quality issues at Boeing, especially with its 737 Max and 787 Dreamliner, and with P&W's GTF engine, have contributed to delays in production.

As a result, there is a backlog of 15,000 aircraft, with delivery slots now extending into the 2030s. According to Morgan Stanley, around 1,300 aircraft due for retirement remain in service. This extended usage drives more hours on existing engines, boosting maintenance revenues for suppliers like GKN.

Company specific headwinds, which I believe are temporary, make this an attractive entry point.

GKN is more heavily weighted to Airbus production than to Boeing. Therefore, the announcement in July that Airbus expects to deliver 770 planes in 2024, down from the 800 figure shared earlier, and that its production target for its A320 narrow-body aircraft of 75 per month will be delayed by one year to 2027 was poorly received by Melrose investors. As with most supply issues, these will resolve and have the silver lining of enhanced aftermarket income from more service hours of the existing fleet.

The Pratt & Whitney GTF engine is an important driver of GKN's RRSP cash flow in the coming years. Unfortunately, some components were made using contaminated powdered metal between 2015 and 2021, affecting approx. 1,200 engines. The industry is working to repair an estimated 673 GTF-powered aircraft on the ground; in addition to the impact on confidence, this will cost P&W approximately $4.5bn - $5.5bn in repairs and customer compensation. GKN has a 4% share through its RRSP agreement and will pay out £200m over the next three years.

Melrose's 2024 H1 numbers and guidance, released in July, came in slightly below estimates on OE sales because of the continuing supply chain issues facing the industry and from the disposal of non-core businesses in structures which, as mentioned above, are undergoing significant restructuring. The company also announced slightly higher capex, £300m over 5 years in its additive manufacturing business. Higher capex concurrent with somewhat lower revenue numbers was not well received by the market.

As with many of the investments I find, the numbers are messy in the short term, but I believe they will clear up over the next couple of years. Free cash flows are coming in significantly below net income, raising questions about the quality of earnings. I think some investors might worry that GKN is being aggressive with its accounting.

For example, the company has guided Net income for 2024 of £350m, but FCF to only negative £44m. I think some discrete costs can explain the differences. Embedded in that number is £140m of restructuring costs (which are now mostly complete), £70m payment for the GTF powder metal issue which will end in the next 2.5 years), and perhaps £50m in added working capital due to supply issues with Airbus and Boeing. Reversing out these temporary issues brings FCF to approximately £215m (or a much more reasonable 60% net income). By 2026, net income could increase by £200m to £500m, with a corresponding increase in 2026 FCF to approximately £400m.

FRS accounting rules governing income recognition for Melrose's RRSPs further exacerbate the uncertainty over cash flow. As discussed previously, most of GKN's components do not require replacement for the life of an engine; GKN is deemed to finish its work at the time of delivery of components. Under IFRS, it must report revenue and profit at the time of sale and estimate the actual profits it will receive from aftermarket many years into the future. Actual cash flows do not come in for some years until the engines make shop visits for maintenance, creating a significant timing issue, where profits are much higher in the short term than cash flows.

In discussions with other investors, my understanding is that the cash mountain in the graphic above is derived from audited third party numbers from GE, Safran, and MTX (another supplier). If anything, Melrose likely takes a more conservative approach to estimating future profits in its accounting, with scope for upward revisions.

Numbers

The following simplistic valuation exercise shows the potential attractiveness of the investment. If we take management's guidance for 2025 of £3,800 in revenues and assume it can grow 8% a year, in line with estimates for industry growth, we get to approximately £4,500m. Suppose we further assume operating margins increase from management's 2025 guidance of 18% to 20%, given the continued restructuring initiatives and high-margin aftermarket income streams. In that case, we have an approximate aerospace operating profit of £900m. Deduct corporate costs of £30m gives £870m in operating profits for 2027. Assuming a 14x multiple, in line with today's multiple and not factoring any multiple expansion for improved clarity on cash flows, and at a discount to comparables such as OEMs and suppliers, which average 16x, gives us a share price of ~£8 vs £4.55 at the end of the third quarter, implying a potential 20% CAGR.

Other factors - Capital Allocation and Longer-term upside

Melrose has set aside £500m for share repurchases. To fund further buybacks, the company may eventually sell the structures business, which is still good but not as good as engines. The company has confirmed that, in the long term, there are few "synergies" between the divisions, and there isn't a solid strategic rationale to keep them under one roof. I think they want to continue building the division up before selling, so it may be a couple of years before any sale. At, say, 10x 2025 operating profit, this would give Melrose £2bn for buybacks, or one-third of the company. The number could be significantly higher to the extent they continue to drive sales growth and margin expansion in the business.

Additive manufacturing has long-term upside potential, which is not factored into earnings forecasts. Additive manufacturing allows for the creation of complex and lightweight components with reduced waste (saves approximately 80% of the material cost), shorter lead times, and increased customization. Melrose recently won a £5bn contract with GE over several years to develop parts using this technology. Melrose had previously invested £40m to develop this technology, and as mentioned above, it is investing a further £300m with an expected IRR over 5 years of over 20%. The current focus is on industrializing or scaling up the technology, potentially opening up several billion in future revenues.

Risks

The primary risks to this thesis are that what I have identified as temporary headwinds may evolve into more fundamental and persistent challenges. Supply chain disruptions in the industry could extend beyond current expectations. GTF powder metal issues may also face prolonged resolution timelines, exacerbating operational delays and increasing costs more than initially forecasted. The GTF engine platform, an important contributor to future cash flows, is relatively new, and future sales growth may be weaker than expected. GKN may be less successful in winning placements in future engine platforms. I could be wrong about cash flow expectations over the next few years and the visibility of cash flows in RRSPs.

Over the very long term, the increasing importance of new markets, such as China, could disrupt the Airbus-Boeing duopoly. Changes in technology to electric or hydrogen propulsion could change the dynamics of the engine market and Melrose's competitive positioning.

(Big thank you to Daniel at Crossroads Capital for bringing this opportunity to my attention).

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Results are net of all standard fees calculated at the highest rate charged, expenses and estimated incentive allocation. Model portfolio returns are inclusive of the reinvestment of dividends and other earnings, including income from new issues. The return is based on annual returns since inception and does not give effect to high water marks, if any. Returns may vary for investors who are restricted from participating in new issues.

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