January 2022

Dear Fellow Investors,

In 2021 stimulated demand and pandemic-related supply chain constraints led to increased inflation. The Federal Reserve is now set to reverse monetary stimulus, both by raising interest rates and by halting its bond buying programs that have injected liquidity into capital markets. At the time of this writing the S&P 500 is about 10% off its high level, and price declines in the frothiest corners of the stock market have been severe. High multiple stocks are acutely sensitive to interest rates. The selloff of 50% or more in many of these stocks is presenting opportunities to own fast growing companies at more reasonable multiples. Sweetbay has used these share price corrections to increase our holdings in several of our highest conviction growth investments, including Block (formerly Square), JD.com, and Alibaba. In the second half of the year we made one new investment, described below.

New Investment

Spirit AeroSystems (SPR)

Spirit AeroSystems designs, engineers, and manufactures commercial aircraft fuselages, wing structures, nacelles and thrust reversers, and struts and pylons for mounting engines to wings. It has a nearly one-quarter share of the global non-OEM aerostructures market. Spirit was for many decades a subsidiary of Boeing, which still accounts for about 60% of revenues, while Airbus accounts for 20% and defense and aftermarket make up the balance. Since being spun out of Boeing in 2005, Spirit has leveraged 7% annual revenue growth into 9% per-share earnings growth thanks to its heavy allocation of cash flow to share repurchases. Over the next 20 years Boeing expects global industry commercial aircraft fleet growth to outpace global GDP growth, providing a nice tailwind for Spirit. But the grounding of the Boeing 737 MAX followed by the Covid pandemic caused Spirit's revenues to decline by nearly 60% in 2020, and the shares followed suit. Over the intermediate term, commercial aircraft deliveries should accelerate above trend to fill the gap left by these exogenous events, which together caused the loss of about a year's worth of supply. A discounted share price for a strong franchise with pent-up demand is, in our view, an advantageous investment foundation.

Prior to the grounding of the Boeing 737 MAX, over half of Spirit's revenues were generated from components of that aircraft. The Boeing 737 is the most successful aircraft in history, completing roughly 240 million flights in the 50+ years since its 1967 debut. Its primary competitor, the A320 family of jets produced by Airbus, was upgraded in 2016 to the A320neo. The new variant's larger

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engines provided better fuel economy and longer range than its predecessor, and it was well received in the marketplace. In response Boeing introduced the 737 MAX, the fourth generation Boeing 737. Because of the low profile of the 737, the larger engines on the MAX needed to be mounted a bit forward of the wing in order to clear the ground. This change slightly altered the aircraft's stall characteristics, which Boeing addressed with a newly designed automated control function known as Maneuvering Characteristics Augmentation System (MCAS). The FAA tested and certified the 737 MAX, and it entered service in 2017. It completed about 650,000 flights before being grounded in March 2019 after two fatal crashes – by Ethiopian Airlines and Indonesia's Lion Air. The 737 MAX accident rate of 3/1,000,000 flights compared to accident rates of around 0.2/1,000,000 for most modern variants of Boeing and Airbus aircraft.

Spirit's shares fell sharply after the 737 MAX was grounded. The issues surrounding the 737 MAX had nothing to do with Spirit AeroSystems, which was simply collateral damage. Boeing implemented changes to the MCAS software. Among several safety improvements that incorporate lessons from the crashes, MCAS will now compare information from both of an airplane's AOA sensors in case one is faulty, as was the case in both crashes. Boeing scrutinized those updates through more than 1,100 test flights, and the FAA recertified the aircraft in late 2020.

The production rate of the MAX remains depressed, but it is steadily ramping back up. Production more than doubled year-over-year in 2021, and it should again double in 2022 to about 25 aircraft per month. Over the next couple of years Spirit should progress toward the rate of 50 aircraft per month achieved prior to grounding.

The last few years have shown the company's resiliency. Its balance sheet is in good shape to weather the challenges. Net debt is 2.0x 2018 EBITDA (before the 737 MAX grounding), there's $1.4b of cash, and cash burn in 2022 should be less than $200 million. Debt maturities are minimal until 2025. In the five years prior to the Covid pandemic, Spirit generated $2.9 billion of free cash flow and used most of that cash to reduce its share count by 25%. Sweetbay invested at a market cap of $4.5 billion, or about 7.5x prior peak earnings compared to a historical average earnings multiple of 15x. As aircraft production returns to normal the multiple should also return to its historical average. In that scenario, earnings growth boosted by share repurchases and capitalized with an expanded multiple would lead to a tripling of the share price over the next several years. In time, I believe the MAX issue and its weight on Spirit's share price will be history.

Please reach out to me directly with any questions about your account(s).

Cordially,
Ted Crawford

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