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EDAC Offers Investors Huge Upside, A Potential Double

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It's not everyday we come across such a massive mispricing in the market as that of EDAC Tech (EDAC) at these levels, but nonetheless we are amazed at the upside opportunity presented by this stock.

As part of our process, we employ a discounted cash-flow model to arrive at a fair value estimate for every company within our equity coverage universe. In the case of EDAC Tech, a nano-cap aerospace supplier of precision components to jet engine makers, we think the shares are significantly undervalued at today's prices of roughly $5 per share. Based on our DCF process, our fair value estimate for EDAC Tech is $10 per share (assuming a 9.4% weighted average cost of capital), and we reveal our forecasts and valuation summary below to make our case for investors interested in picking up a potential double.

Valuation Summary

Edac Technologies	EDAC
Fair Value -- the instrinsic value of the firm	10.00
Upside -- the upside potential based on historical volatility of operating performan	14.00
Downside -- the downside potential based on historical volatility of operating perf	6.00
Phases of the Model	
Phase I Present Value -- the value generated between years 1 through 5	9
Phase II Present Value -- the value generated between years 6 through 20	35
Phase III Present Value -- the value generated after year 20	24
Total Firm/Enterprise Value (present value) -- the sum of Phase I-III present values	68
Net Balance Sheet Impact -- cash less debt less other adjustments	(18)
Total Equity Value -- the residual value belonging to shareholders	50

For starters, let's evaluate EDAC Tech's performance through the first six months of this year (on next page).

EDAC TECHNOLOGIES CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)
For the three and six months ended July 2, 2011 and July 3, 2010

(in thousands except per share amounts)	For the three months ended July 2, 2011	For the three months ended July 3, 2010	For the six months ended July 2, 2011	For the six months ended July 3, 2010
Sales	$ 21,880	$ 18,841	$ 42,079	$ 36,628
Cost of Sales	18,249	16,583	35,639	32,229
Gross Profit	3,631	2,258	6,440	4,399
Selling, General and Administrative Expenses	1,903	1,529	3,848	3,260
Income from Operations	1,728	729	2,592	1,139
Non-Operating Income (Expense):				
Interest Expense	(273)	(226)	(533)	(452)
Other	3	-	8	360
Income before Provision For Income Taxes	1,458	503	2,067	1,047
Provision for Income Taxes	481	158	682	343
Net Income	$ 977	$ 345	$ 1,385	$ 704
Income per share data (Note A):				
Basic Income Per Common Share	$ 0.20	$ 0.07	$ 0.28	$ 0.15
Diluted Income Per Common Share	$ 0.19	$ 0.07	$ 0.27	$ 0.14

Source: EDAC Tech's 2Q Form 10-Q.

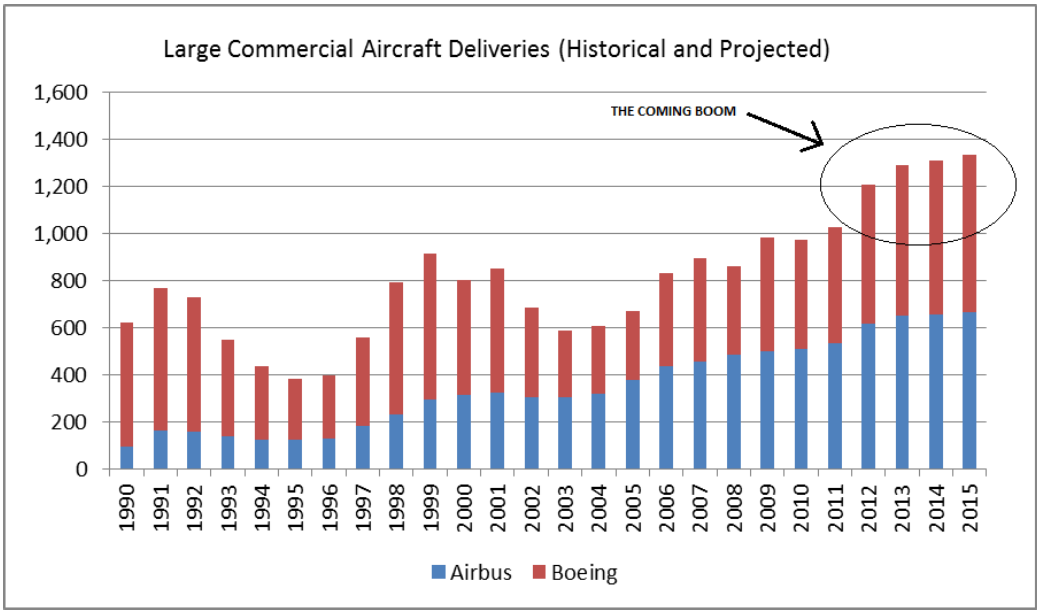
As you can see from the performance thus far this year, EDAC is on track to earn roughly $0.54 per share in 2011 (diluted income per common share was $0.27 through the first six months). Importantly, however, the firm's second quarter results are more revealing of the trajectory of the firm's business, in which it earned $0.19 per share. From our second-quarter earnings note:

> EDAC's revenue reached record levels, jumping 16%, while net income almost tripled. Sales in all three of its major product lines improved – EDAC Aero, APEX Machine Tool and EDAC Machinery – while the firm's bottom line improved materially thanks to more cost-effective manufacturing and a better product mix (gross margin increased 460 basis points in the period) ... The company's backlog now stands at $168 million, up from $134 million sequentially (that's just three months ago), and represents over 6 times its market cap. We believe this backlog to be of the higher-margin variety, and increased throughput should continue to drive margin improvement.

We think the firm's second quarter performance is more indicative of what investors can expect in the third and fourth quarters, where we are forecasting earnings per share of $0.12 and $0.19, respectively - putting our full-year 2011 earnings per share forecast at $0.58. By extension, EDAC Tech is currently trading at about 8.5 times this year's earnings and less than 7 times next year's earnings (based on our forecasts). These are ridiculous multiples.

Let's dig a bit deeper into the sustainability of this performance. On EDAC Tech's second-quarter conference call, the firm noted that it expects a slight sequential decline in revenue (5-10%) in its third quarter due to seasonality (which explains our relatively lower third-quarter EPS forecast), but noted that revenue should be particularly strong in the fourth quarter of this year as it begins to recognize revenue from a recent large European order.

Regarding sustainable long-term growth, EDAC has secured a nice position on the geared turbo fan engine from United Technologies (UTX) - which represents about 40%-50% of total revenue - and also has a presence on CFM's (GE/Safran) LEAP-X engine, which is an option offered on the best-selling A320neo (new engine option). We expect commercial aircraft deliveries in the next few years to expand considerably, led by increased production rates by Boeing (BA) and Airbus in the narrowbody segment (A320, 737). The recent Paris Air Show and American's (AMR) large order for 460 replacement planes this year speak to the strength of commercial aerospace in coming years.



Importantly, however, EDAC noted that it expects to continue to improve margins in the years ahead, which will be a critical driver behind earnings expansion. Given the operating leverage we've seen out of other jet-engine suppliers like Precision Castparts (PCP) during previous cycles, we're fairly confident in the company's claim regarding margins. We reproduce management's comments from its second-quarter conference call:

> Q: I'm just curious about the sustainability of margins at this level ... I mean it's really a remarkable improvement and I was just wondering if you can retain these levels.
>
> EDAC: Our objective is to maintain these levels and by no means be our ceiling. We hope to continue to improve as we work through our development parts that we have done last year and this year. We are very optimistic that we'll able to continue to hold or improve these margins.

With the company's top-line growth trajectory and the prospects for further margin enhancements, we would not be surprised to see the firm earn $0.72 next year - less than 7 times its current price on the heels of about 25% earnings growth. Of note, we don't expect EDAC Tech to achieve the gross margin levels that it achieved in its second quarter (about 16.6%) - the levels management says it can maintain and improve upon - until 2013 (see below), meaning our $10 per share fair value could even be conservative. We expect EDAC Tech to expand earnings at a double-digit pace going forward given the expected strength of the commercial aerospace cycle, which we had outlined above.

We reproduce our income-statement forecasts for EDAC Tech on the next page:

INCOME STATEMENT					
in millions of currency units	Year 1	Year 2	Year 3	Year 4	Year 5
Fiscal Year	*2011*	*2012*	*2013*	*2014*	*2015*
Total Revenue	82.6	93.7	104.3	113.9	121.9
Total Revenue, YoY%	13.0%	13.5%	11.3%	9.2%	7.0%
Revenue Upside	86.0	101.6	117.5	133.1	147.6
Revenue Downside	79.1	85.8	91.1	94.7	96.1
Cost of Sales with Depreciation	69.8	78.5	87.1	94.8	101.1
Cost of Goods Sold, % of Total Revenue	84.6%	83.8%	83.5%	83.2%	83.0%
Gross Margin	12.7	15.2	17.2	19.1	20.7
Gross Margin %	15.4%	16.2%	16.5%	16.8%	17.0%
SG&A	7.7	8.6	9.5	10.3	11.0
Selling, General & Adminstrative Expenses, % of Total Revenue	9.3%	9.2%	9.1%	9.1%	9.0%
Total Other Operating Expenses (including R&D), ex unusual items	0	0	0	0	0
Other Operating Expenses (including R&D), ex unusual items, % of Total Revenue	0.0%	0.0%	0.0%	0.0%	0.0%
Depreciation	3.0	3.5	3.8	4.2	4.5
Depreciation, % of Total Revenue	3.7%	3.7%	3.7%	3.7%	3.7%
Depreciation, YoY % Growth	13.0%	13.5%	11.3%	9.2%	7.0%
EBITDA	8.1	10.0	11.5	13.0	14.2
EBITDA Margin %	9.8%	10.7%	11.0%	11.4%	11.7%
EBITDA, YoY % Growth	81.5%	23.9%	15.2%	12.8%	9.5%
Total Expenses, ex unusual items	78	87	97	105	112
Operating Income after Depreciation	5.0	6.6	7.7	8.8	9.8
Operating Income (EBIT) Margin, ex unusual items, % of Total Revenue	6.1%	7.0%	7.4%	7.7%	8.0%
Operating Income (EBIT), ex unusual items, YoY % Growth	186.1%	30.2%	17.2%	14.6%	10.7%
Other Income, Net (includes in-process R&D, restr/M&A, other special charges)	0.0	0.0	0.0	0.0	0.0
Interest Expense	-1.0	-1.0	-1.0	-1.0	-1.0
Pre-tax Income	4.4	5.6	6.7	7.8	8.8
Income Taxes	1.5	1.9	2.3	2.7	3.0
Effective Tax Rate	34.0%	34.0%	34.0%	34.0%	34.0%
Net Income before disc op's/extraordinary items	2.93	3.69	4.43	5.17	5.80
Net Income Margin bef disc op's/extra items, % of Total Revenue	3.6%	3.9%	4.2%	4.5%	4.8%
Net Income before disc op's/extra items, YoY % Growth	245.2%	25.7%	20.2%	16.7%	12.0%
Disc Op's/Extra items (inlcuding acct change/tax loss carryforward, other gains)	0	0	0	0	0
Total Net Income	2.9	3.7	4.4	5.2	5.8
Preferred Dividends	0	0	0	0	0
Diluted Weighted Shares Outstanding	5.07	5.13	5.19	5.26	5.32
Diluted Earnings per Share, ex items	0.58	0.72	0.85	0.98	1.09
Diluted Earnings per Share, YoY % Growth	241.1%	24.2%	18.7%	15.3%	10.7%

In all, we think EDAC Tech is significantly undervalued in the $5 per share range. And as it relates to our conviction in the call, the name represents the largest holding in our Best Ideas portfolio at this time.

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