BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

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TransDigm (TDG) EQ Update- 9/20 Qtr.

Current EQ Rating*	Previous EQ Rating
3-	3-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

*For an explanation of the EQ Review Rating scale, please refer to the end of this report

We are maintaining our earnings quality rating of 3- (Minor Concern)

TDG beat estimates handily in 4Q20 by $0.94. It should be noted that adjusted EPS was $2.89 for a company accustomed to earning about $5 per quarter. TDG always adds back stock compensation to adjusted EPS, but in the 4Q, it was $11 million higher y/y which helped adjusted EPS by an incremental $0.24. Income taxes in the quarter were also a $25 million credit vs. a $50 million expense a year ago. The $25 million credit was worth $0.44 per share, had it been the same rate as a year ago, it would have cost TDG another $0.18 per share. TDG also added back more acquisition items in a period without acquisitions than last year and added back $0.39 in COVID-related costs where $22 million related to workforce payments and only $1 million to cleaning supplies and PPE.

What we are most concerned about is the debt to EBITDA ratio of 6.64x times. Even TDG expects it to rise to 8x as stronger quarters roll-off and are replaced by weaker ones. That could make it difficult for TDG to follow its normal pattern of making acquisitions with debt and paying large dividends. Without that model, we see TDG as a company with low organic growth and weak earnings quality because of how it accounts for deals:

- Not amortizing the bulk of purchase costs by assigned assets to Goodwill
- Amortizing other assets over periods much longer than internally built assets
- Adding back numerous recurring costs to adjusted EBITDA and EPS

What improved?

- **TDG boosted bad debt expense** from $5 million to $21 million during the year – this **cost them 22-cents in full-year EPS.** That is with receivables declining from $1.07 billion to $720 million. The lower receivable figure also helps insulate TDG from commercial customers who may restructure debt in court.

- **TDG boosted inventory reserve expense** from $17 to $34 million on essentially flat inventories. **This cost them 23-cents in full-year EPS.**

What deteriorated?

- **Net debt is $15.1 billion as trailing EBITDA fell to $2.3 billion for a ratio of 6.64x. Annualizing 4Q results, the ratio is now 7.56x.** It since has spent $965 million on an acquisition – which assuming that boosted net debt – the ratio would be above 7x already on a trailing 12 months. It is possible TDG will need to adjust covenants as the maximum leverage multiple is 7.25x if it needs to borrow more on the revolver. High debt may result in limitations on dividends for a longer time too.

- **The $7.9 billion in Goodwill (43% of assets) is now considered a critical audit matter at TDG.** The company evaluates the value of its assets based on future cash flows. We know from Air Lease that new planes are coming into fleets slower than anticipated and that has been the case for multiple years. That should be cutting into the OEM business. Also, older planes are being retired more quickly as airlines look to scale down capacity and focus on their most efficient planes. That should be cutting after-market sales. Organic growth fell 13.8% in 2020. We don't expect an impairment from acquired defense units, but the risk on commercial aviation may be increasing.

What to watch

- Defense revenues rose 7% in 4Q and 9% for 2020. We know from General Dynamics that the government accelerated payments to defense contractors wanting them to order more from various subcontractors and strengthen the businesses in that industry. We're not saying defense spending will turn negative, but we would expect the growth to slow as COVID issues are solved.

- There were no new disclosures regarding audits by the government since TDG's voluntary refund of $16 million in 3Q19. We still think investors should be aware of this risk as TDG again pointed out on the conference call that one of its operating levers is to make acquisitions and essentially boost prices and cancel volume discounts. Also, on the acquisition front, TDG noted it is not seeing much in commercial aviation of interest at this time, deals are more focused on defense but multiples appear high.

- **Cash from operations benefited from a $352 million drop in A/R** offset by $62 million used in both inventory and payables for 2020. In the 4Q, the benefit was a net $55 million. We doubt these accounts will decline much more and are more likely to become cash headwinds. **This was 19% of Cash from Operations in 2020 and 25% for 4Q20. Even the company expects the receivables to rise going forward.**

- **Income is still inflated from a loss reserve taken in 2019 that is being amortized as a reduction to Cost of Goods Sold going forward. This was $36 million in 2020. That added 71bp of gross margin and 50-cents in EPS for 2020.**

The Debt Issues:

TDG issued new debt to bolster liquidity as COVID hit. The result is it has a net $15.1 billion in debt after deducting $4.7 billion in cash. The company already has borrowed $350 million against receivables but only has $200 borrowed on its revolver of $760 million.

Trailing 12 months adjusted EBITDA is $2.3 billion which gives TDG a net debt/EBITDA ratio of 6.64. Annualizing 4Q of $498 million in EBITDA gives a ratio of 7.59x. Based on the conference call, TDG expects this ratio to hit 8x before operations recover enough to start pushing it down again. Also complicating this is post-quarter, it made a $965 million

acquisition with cash. That could have the ratio already as high as 7.06x on trailing 12 months or 8.07x on annualized 4Q results.

This is important because:

- TDG has to keep debt under 7.25x if it borrows more than 35% of revolver availability, which is $266 million. It has $200 million now and $39 million for letters of credit.

- Given that covenant, we would consider the revolver to already be maxed out as the company expects to top 7.25x and may already have.

- There are also $7.45 billion in term loans at TDG. When leverage exceeds 5.0x – then 50% of excess cash flow needs to be applied to prepaying the term loans.

- Excess cash flow is – Net income + noncash charges + declines in working capital – capital spending – required debt payments + cash from asset sales.

- When we look at basic cash flow which would essentially be income + noncash items + working capital changes, it appears unlikely that TDG will be paying dividends in the near future.

	2020	2019	2018	2017
Cash from Operations	$1213	$1,016	$1,022	$789
Capital Spending	$105	$102	$73	$71
Free Cash Flow	$1108	$914	$949	$718
Acquisitions	$0	$3,976	$668	$216
Dividends	$1928	$1,712	$56	$2,582

In 2020, that was a $32.50 per share dividend and in 2019 it was $30.00 per share. The company warns in the 10-K, not to expect this recur anytime soon:

> *"Notwithstanding special cash dividends, of which the most recent declaration by the Company's Board of Directors occurred on December 20, 2019 in the amount of $32.50 per outstanding share of common stock and and cash dividend equivalent payments on options granted under its equity compensation plans,* ***we do not***

anticipate declaring regular quarterly or annual cash dividends on our common stock or any other equity security in the foreseeable future."

We should also add that in 2020, TDG's cash flow benefitted from receivables declining by $352 million, and the total change in A/R, Inventory, and Payables helped cash flow by $228 million and TDG expects that to reverse too according to the CFO on the call:

> *"If you peel the onion back a little bit, you would see,* ***accounts receivable was basically a source of cash for us of about $350 million, it was down 36% or so on the year.*** *That was just driven by the commercial end market declines in the fact that we've been driving collections from the customers. So the sales drop provided you keep collecting in 57 days, which is about our average. Your accounts receivable sort of resets to your current sales level; that amount of cash is, obviously when we get back up to – and the commercial markets fully recovered.* ***The $350 million is going to have to go back in****…"*

Thus we see EBITDA declining as pre-COVID quarters fall off, which drives up the debt ratios. At the same time, there will be lower cash flow from that plus increased working capital drain and the term loans will require additional payments.

Also, how does TDG grow in the next couple of years? Organic growth is about 2%-3% in most years. It just finished a -14% organic growth year – which should recover over time. Acquisitions funded with debt have been the big source of growth. TDG normally buys a business with lean operating costs and boosts margins by having management retire, consolidating the back-office operations, raising prices, and potentially introducing the parts to more of its existing customers. Acquisition-led growth has consumed almost $9 billion in cash since 2015 at TDG. How much more debt can they put to work in this industry and this growth model at this time?

Explanation of EQ Rating Scale

6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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