BEHIND THE NUMBERS
Quality of Earnings Analysis

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TransDigm Group Inc. (TDG) Earnings Quality Update 12/20 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are reducing our earnings quality rating of TDG to a 2- (Weak)

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

Summary

TDG reported adjusted EPS of $1.97 in the 1Q21, which missed the consensus by 4-cents. Our biggest issues with TDG are its debt level and that it adds back numerous recurring costs while enjoying some windfall sources of profit not in guidance. For example, in 1Q21, the company was guiding to an 18-22% tax rate. It came in at 5.5% for the quarter. Much of this is due to a tax shield on dividend equivalents recognized on stock option plans. However, that is a recurring item.

TDG's Covid costs are not going down either and are being used to pay costs associated with laying off workers. These are cash costs, look like restructuring to us as the company thinks rehiring will happen on a lagging basis as business recovers, and this is the bulk of the Covid cost. In 3Q20, TDG said Covid cost $24 million with only $3 related to cleaning, changing workplaces, etc. The last two quarters, Covid has been $22 million and $21 million with only $1 million in Covid cleaning protocols. In 1Q21, this added back about 27-cents to adjusted EPS for what does not look like Covid expenses.

TDG also added back $18 million in loss contract amortization in 1Q21 or about 24-cents in EPS vs. $11 million or 15-cents in EPS the prior year. Even their auditors highlighted this as a critical matter when TDG set it up because it requires significant management speculation and opinion on doing this transaction. We'll describe this more below.

Even TDG sees its Net Debt/EBITDA ratio reaching nearly 8x this year. What if air travel takes 2-3 more years to recover more fully? EBITDA is already overstating what actual cash flow is because of the high interest expense figure. Meanwhile, net debt of $16 billion may get close to 8x EBITDA of $2.0-$2.1 billion. The actual cash from operations is likely going under $1.0 billion as working capital rebuilds and capital spending is over $100 million already. There is still $4 billion in cash as part of the net debt picture here so TDG has liquidity available. TDG's stock gets a premium valuation because it makes frequent acquisitions to drive growth and pays high special dividends. It does not look like TDG can justify either at the moment.

What is weak?

- **Lower tax rates are a big help to recent results. The problem is the effective tax rate should increase next year.** The tax reform act limited the amount of interest expense that a company could use as a tax shield to 30% of the sum of EBITDA + Interest Income starting in 2019. The CARES act moved that percentage to 50% for years 2020 and 2021. Estimating this based on TDG's EBITDA of $2.3 billion, the amount of interest expense that is deductible went from $683 million to $1.1 billion in 2020. Since interest expense was $1.03 billion in 2020, it is fully tax-deductible. **The difference in the tax code added almost $73 million to earnings or $1.27 in EPS.** Likely that was not fully seen in 2020 because TDG's fiscal year started in October 2019. TDG is guiding to interest expense at essentially the same figure for 2021, which should again make it fully deductible (although EBITDA declining may keep a small part of interest out of the tax shield). In 2022, this formula not only reverts from 50% to 30% again – they will be using EBIT not EBITDA to determine the 30% level. On 2020 figures, that would have only allowed TDG to shield $599 million of interest expense. Using the same EBITDA figures and interest expense under the three situations and making starting point $0.00, the CARES ACT is adding $1.27 to EPS, as that expires and the EBIT rule kicks in, income will fall $90 million below the starting point and EPS will fall $1.58. The swing from 2021 to 2022 would be $2.85.

- Loss Contract Reserves are an odd source of adjusted earnings. On some acquisitions, TDG identified contracts in place that were non-economic. So TDG compared the expected value of that contract to one signed under current market terms. The difference is set up as a loss contract reserve. That reserve is amortized through GAAP earnings.

However, for adjusted EPS – TDG adds the amortization back to income as being non-cash. The result in our view is this gives adjusted results a picture that the contract is generating the profits of a different deal while GAAP still reflects the reality of the loss.

In 1Q21, amortization of this account was $18 million up from $11 million in 1Q20. This added 24-cents to adjusted EPS of $1.97 vs. 15-cents in 1Q20 of $4.93. For all of fiscal 2020 – this was 50-cents of EPS.

- The Catch-22 for TDG is its operating model relies on making acquisitions or it posts organic growth rates of 2%-3% in most years. Also, one of the big ways it improves acquisitions is canceling volume discounts and/or boosting prices so it gets a bump in revenue early on. So a company that makes one deal can argue that some of the acquisition-related costs for legal issues, debt issues, combining software systems, consolidating real estate are one-time items. When a company makes 70 deals and touts that as the operating model – those items are recurring costs in our view and TDG is inflating adjusted EPS and EBITDA by adding them back in our opinion. TDG goes beyond that by adding back stock compensation as a huge part of this too and that occurs every quarter with or without acquisitions:

EPS Adjustments	**1Q21**	**4Q20**	**3Q20**	**2Q20**	**1Q20**
GAAP EPS	-$0.42	$1.76	-$0.09	$5.63	$0.83
Refinancing	$0.00	$0.02	$0.01	$0.05	$0.30
Acquisition Exp.	$0.05	$0.42	$0.24	$0.35	$0.24
COVID	$0.27	$0.39	$0.43	$0.00	$0.00
Stock Comp	$0.64	$0.57	$0.31	$0.16	$0.34
Dividend Equivalent	$1.24	$0.00	$0.00	$0.00	$3.22
Taxes	-$0.16	-$0.48	$0.58	-$0.95	-$0.22
Other	$0.32	$0.21	$0.06	-$0.14	$0.22
allocated Loss	$0.03	-	-	-	
Adj. EPS	$1.97	$2.89	$1.54	$5.10	$4.93

Refinancing happens continually. Acquisition integration recurs all the time. Covid has been including workforce payments with only minor amounts for what sound like Covid protocols. Stock compensation covers the expense that TDG is adding back, the dividend equivalent payments made annually on the stock compensation plans, and largely impact the taxes on the adjustments to deal with withholding taxes and compensation issues. If one only considers the stock compensation-related expenses as recurring items and part of the earnings model – that alone was 25% of adjusted EPS in 2020.

What to watch

- No impairments of Goodwill or Intangibles yet? This has surprised us because TDG is designed to be a serial acquirer of companies that sell airplane parts. Equity is -$3.7 billion, PP&E is only $777 million, working capital is only $1.0 billion, while Goodwill is $7.9 billion and Intangibles $2.6 billion. Despite many planes being idled – TDG has taken no impairment and reports that if they used a 100bp higher discount rate, it still would not see one. We have several areas of concern on this front:

    - The basic economic model for TDG is a plane model having a life of 20-30 years and how many are built and sold over that life and then operated for 10-20 years longer. They can estimate new parts and replacement parts doing that and value the goodwill.

    - We know from AirLease that airlines around the world have grounded their older planes and kept the new planes flying. This saves fuel and should save maintenance costs too. That should hurt TDG sales of replacement parts for a longer time.

    - Some of the older planes may retire sooner than expected and that would mean a lower jet fleet overall for TDG to serve.

    - What if many existing planes that are 15-18 years old, don't fly again but were expected to go on for 15-20 years? What if many larger planes are retired too – with the remaining ones flying long international routes 3x a week instead of 7x? What if Covid issues create a 3-year hole in the aviation industry where the fleets are not fully utilized and therefore not replacing parts at past rates? The plane is still aging and facing retirement questions.

    - We do not think it would take much of these scenarios to drop future cash flow projections for several products in the TDG commercial portfolio by 20%-40% regardless of the discount rate. (The defense-related parts should not have this issue). Then remember the goodwill isn't being amortized, about one-third of other intangibles are trademarks and are not being amortized. The acquired technology is being amortized over 20-22 years. This isn't an issue that gets smaller as time goes forward since the balances are not declining much.

- **TDG is touted as a company that grows through acquisition and gives shareholders returns via growing EPS, growing EBITDA, and high dividends. We wonder if this model can work like that for the next several years:**

Cash Flow	2020	2019	2018	2017	2016
Adj. EBITDA	$2,278	$2,419	$1,877	$1,711	$1,495
Cash from Ops	$1,213	$1,016	$1,022	$789	$683
Cap Exp.	$105	$102	$73	$71	$44
Acquisitions	$0	$3,976	$668	$216	$1,399
Free Cash Flow	$1,108	-$3,062	$281	$502	-$760
Dividends	$1,928	$1,712	$56	$2,582	$3
Debt/EBITDA	6.7	6.4	5.8	6.5	6.8

  - Even when they were running the acquisition model, the company was ratcheting up debt to pay for acquisitions and dividends.

  - Cash flow was always much lower than EBITDA because of the huge interest cost on the growing debt.

  - EBITDA will decline as pre-Covid quarters roll off and TDG already boosted debt with an acquisition in January. The company expects the debt multiple to approach 8x as it spent almost $1 billion of its cash after 1Q21.

  - EBITDA was helped in 2020 by cutting costs amid falling revenues – TDG has said that those costs will return as business picks up even if it's on a lagging basis. Returning to $2.4-$2.5 billion for EBITDA may take years.

  - Cash from operations was helped in 2020 by a positive $350 million y/y swing in working capital. As business returns, working capital should rebuild too and be a drain on cash flow.

  - In 2021 and 2022, TDG will need to pay the deferred FICA taxes and in 2022, the tax law changes and should boost income taxes too – both should have negative impacts on cash flow.

  - We think this shapes up as a company with cash from operations of under $1 billion, free cash flow of under $900 million before acquisitions, carrying debt of 7-8x EBITDA – how does it pay dividends of any material amount? And if it doesn't make deals, how does it justify a P/E of 29 based on a normal adjusted EPS of $20?

- While TDG was able to roll over some debt in 2021 at a lower rate, if business improves, do rates stay this low? A 50bp rise in interest rates is $100 million in higher expense. As the CARES act tax rules change in 11 months, we know TDG will lose more of its tax shield on interest so an increase in interest expense would come straight out of the cash from operations line.

- We think there will be more pressure to pay down debt sooner rather than later for TDG. The tax issues make it tougher for the EBITDA to carry as much debt as would rising interest rates.

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 Concern)- 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 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 upcoming quarters. 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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