BEHIND THE NUMBERS
Quality of Earnings Analysis
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TransDigm Group Incorporated (TDG)
Earnings Quality Update- 3/21 Qtr.

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

We are raising our earnings quality rating of TDG to a 2+ (Weak) rating from 2- (Weak).

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

Summary

TDG beat forecasts for fiscal 2Q21 (calendar 1Q) by 4-cents. The quarter included adding back $6 million of inventory cost – which helped EPS by 8-cents. This inventory adjustment results from acquisitions where TDG marks up the value of inventory, which effectively cuts gross margin. It then takes out the fair market value increase from adjusted EPS. There was also $9 million in loss-contract amortization added back – that helped EPS by 12-cents. This occurs when TDG makes an acquisition and determines existing contracts are below-market rates. It books a loss for the contract based on what TDG determines the current market price should be and sets up a reserve for the difference. GAAP records both the higher assumed market price and amortizes the loss into income. Adjusted EPS adds back the loss amortization.

It was another quarter where TDG added back $18 million in COVID costs while also stating that only $1 million was for actual extra COVID cleaning that will not recur. The extra $17 million was worth 24-cents in EPS. We think investors should also be aware of the following:

- TDG uses Average-Cost and FIFO Inventory methods for determining Cost of Goods Sold. TDG's operating model is built for rising raw material costs to help drive margins

and earnings. Inventory turns less than 2x per year. However, TDG raises prices quickly to customers:

	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19
Inventory Turn	1.94	1.77	1.99	0.58	1.90	2.05	2.14	2.54

On the call, TDG again pointed out that it doesn't make deals for volume discounts and other areas that would reduce prices for customers. It also noted that it has contracts that let it pass through rising materials costs. According to TDG's president,

"We are very disciplined in adding back costs. We will do so in a very disciplined manner. We will pass along, of course, increased costs in terms of inflationary pressures."

It is also insulated because 60% of gross inventory is raw materials and parts that would need to be cast/manufactured/assembled to be sold. Work in process is another 25% of gross inventory. Thus, it may well have taken price increases that will enable it to replace inventory, but the bulk of it turns so slow it will be selling lower-cost supplies at higher prices.

Also, keep in mind that labor is part of the inventory cost and TDG has been slow in bringing employees back as sales are still weak. It is possible that it could continue to try to bring back workers at a slower rate than sales and that could also help the gross margin going forward for a couple of quarters:

	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19
Gross Margin	49.6%	48.7%	45.7%	48.0%	56.7%	54.7%	57.2%	46.9%
Gross Profit	$592	$541	$536	$491	$818	$801	$882	$713

Margins are showing this already, but sales remain pressured. Even on current sales levels, 100bp of gross margin is worth 16-cents in quarterly EPS. So the using FIFO accounting could help TDG's earnings with inflationary pressures.

- Inventory reserves have also been boosted considerably in recent quarters. They may have topped out in 2Q21. If this declines going forward, it could also help gross margin:

	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19
Inv. Reserves	$190	$189	$178	$162	$151	$134	$124	$117

Total net inventory is only $1.24 billion so the reserve is 13% vs. about 9% pre-COVID. TDG may be in a position to not add much to reserve in the next few quarters and that could help EPS too. Every $10 million decline here is worth about 14-cents in quarterly EPS.

- The debt load remains a big issue for TDG as the tax shield is going down under section 163(j). The tax law changed- previously the amount of interest they could shield against taxes was 30% of EBITDA and now that is 30% of EBIT. Under the CARES act during COVID, companies were given a two-year reprieve where they could shield 50%.

  Just looking at last quarter, TDG had interest expense of $268 million. Under the old law, it could shield 30% of EBITDA which was $464 million or $139 million. Under the new law, it can shield 30% of EBIT, which was $394 million or $118 million. The result is going to be a higher tax rate and a higher cash tax payment going forward. This already is happening at TDG as the effective tax rate jumped to 19.6% from 4.2% y/y largely as a result of section 163(j). This will be a headwind for EPS going forward – we estimate about 20-30-cents in EPS per quarter this year.

  We think this effectively reduces ROI and the amount of debt TDG can carry. Also, the longer sales and income stay impaired, the worse this is. TDG has debt of 8.3x trailing 12 months adjusted EBITDA. Pre-COVID, it's carrying 6.7x.

- We also want to point out that TDG thinks the audit into defense contract pricing is going smoothly and appears similar in scope to prior audits. The CFO made these comments on the earnings call:

  "*Lastly, and shifting gears from financial matters, I'd like to provide a quick update on our ongoing U.S. DoD IG audit. We've been actively engaged with the IG office with some ebbs and flows and continue to work through the audit process. And our best assessment and based upon what we see, this ongoing audit appears to be similar in scope to our prior audits. While it's difficult to know exactly when a final report could be issued publicly, we expect that this might happen sometime during Q3 or Q4 of our fiscal '21.*"

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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