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Empty skies

Evan Lorenz writes:

The plunge in air traffic may be the steepest since the Wright brothers trekked to Kitty Hawk, and the attendant drop in hotel-occupancy rates may eclipse those recorded in the Great Depression. Now in progress is a survey of the American travel business with a focus on aviation-parts supplier TransDigm Group, Inc. (TDG on the New York Stock Exchange). As to TDG, *Grant's* is bearish.

According to the Transportation Security Administration, the number of travelers at American airports was down by 95% in the week ended April 27. As of Tuesday, 63% of the world's air fleet was grounded, as recorded by travel-research firm Cirium. No surprise, then, that Delta Air Lines, Inc. is predicting a 90% slump in second-quarter revenues and that the American Hotel & Lodging Association is forecasting an average room-occupancy rate this year of 38%, an all-time low.

Few are flying even in countries that are reopening for business—China, for instance, which accounts for 24% of the world's domestic flights. "While there was an early upswing from mid-February into the first week of March, the number of domestic flights plateaued at just over 40% of pre-Covid-19 levels," the International Air Transport Association noted about the People's Republic the other day. "Actual demand is expected to be significantly weaker as load factors on these flights are reported to be low."

Stay-at-home orders are having just the effect you'd expect them to have on ski resorts, movie theaters, amusement parks and the like. EPR Properties, a REIT that invests in such "experiential" venues, disclosed that, as of April 21, just 15% of its tenants had paid their cruelest-month rent.

And there's the question of when, or even if, business travelers will return in pre-crisis numbers. Corporations will be counting what remains of their pennies when the economy does reopen. However irksome Zoom conferencing might have seemed in the interminable days of lockdown, it could offer stiff competition for physical travel to newly conscientious corporate-expense managers.

"In the second week of May we have a board meeting," an investor and corporate director tells me. "Maybe we will be able to fly by then, but—let's be honest—let's do Zoom or be on the phone. We've all been around long enough, and we don't need to do a lot of face-to-face meetings. Let's just talk about the situation."

According to Trondent Development Corp., a software provider to the travel industry, business travelers typically constitute 12% of airline passengers but deliver around 75% of a typical carrier's profits.

"It took two or three years for passenger volumes to fully recover from 9/11," Seth Borko, a senior analyst at Skift, a company focused on travel-related research, tells me. "It took another three years for earnings, airline earnings, to fully recover," partially because of high oil prices. While crude is cheap today, the plunge in West Texas Intermediate will lead to much lower investment in new wells and the bankruptcy of numerous shale drillers. Maybe, then, when traffic finally does begin to recover, energy costs will be punishingly high.

The knock-on effects of a depression in travel present their own sources of concern. Last year, Expedia Group, Inc. expended $3.5 billion on advertising. This year, that figure won't even touch $1 billion, said Expedia Group chair-

TransDigm Group, Inc. at a glance
all figures in $ millions

	TTM*	2019	2018	2017	2016
revenues	$5,695.2	$5,223.2	$3,811.1	$3,504.3	$3,171.4
operating income	2,064.5	1,926.5	1,655.4	1,482.8	1,267.3
interest income	935.8	859.8	663.0	602.6	483.9
net income	725.7	778.7	900.9	437.6	583.4
cash	4,194.0	1,467.5	2,073.0	650.6	1,587.0
debt	18,382.0	16,899.0	12,877.3	11,762.7	10,195.6
assets	18,156.0	16,254.7	12,197.5	9,975.7	10,726.3

* For the 12 months ended Dec. 28, 2019.

source: company reports

man Barry Diller during his April 16 appearance on CNBC's "Squawk Box."

Borko comments: "We estimated that the travel industry spent as much as $16 billion in advertising on Google, and I think more than half of that is from a handful of big online travel agencies across all their subsidiaries. [For reference, Alphabet, Inc. generated $161.9 billion in sales last year.] You buy an online performance ad because you are bidding for demand and you're willing to pay a price to do that. These guys have very, very smart data-science teams that very carefully track conversion rates, track who views, and they calibrate their return on investment....

"So, we're going to see all these online travel agencies recalibrate their ROI models to a baseline of effectively zero, which is unprecedented," Borko goes on. "It's like a natural experiment: You would never stop all of your advertising spend just to run an experiment, but they've kind of done that....And we'll see if their ad spend is truly as effective as they thought it was. And I suspect it may not be, especially if there's less demand."

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TransDigm, a leading designer, manufacturer and supplier of aircraft components and systems, last year sold equipment in the sum of $5.7 billion. Products ranged from actuators and ignition systems to latches, audio systems and parachutes to seatbelts. In the December quarter, sales to the Defense Department contributed more than one-third of the top line.

"An automobile has about 10,000 moving parts, right?" Alan Mulally mused after taking the helm of Ford Motor Co. in 2006. "An airplane has 2 million, and it has to stay up in the air." In his book *AeroDynamic: Inside the High-Stakes Global Jetliner Ecosystem*, Kevin Michaels contrasts the number of jets that Airbus S.E. and Boeing Co. may build in a given year—around 1,500—with the number of new cars sold in the United States alone—around 17.1 million.

Thus, aerospace manufacturers make lots of parts with limited production runs. But because a plane can remain in operation for as many as 60 years, and because the original equipment manufacturers support their creations over those decades of service, the demand for parts is recurrent and, from the parts-makers' point of view, lucrative. You're put in mind of a book publisher with a strong back list.

TransDigm reports that proprietary products for which it owns the intellectual property deliver 90% of sales. And almost 80% of that revenue is derived from products of which it's the sole supplier.

In the 2019 fiscal year, ended Sept. 30, sales to airlines and distributors, rather than to OEMs like Airbus and Boeing, provided 52% of the top line. Such aftermarket sales of sole-sourced products are especially profitable, as airlines pay up in ways that the big aircraft manufacturers refuse to do.

Formed in 1993 via a leveraged-buyout of the aerospace division of IMO Industries, Inc., TransDigm has a complicated Wall Street genealogy. Suffice it to say that, prior to being listed on the Big Board in 2006, Kelso & Co., Odyssey Investment Partners, LLC and Warburg Pincus, LLC took turns as owners.

Chairman W. Nicholas Howley, who helped to engineer the first, 1993 private-equity transaction, still talks the p.e. lingo. He began the Feb. 4 earnings call by saying, "Our long-standing goal is to give our shareholders private-equity-like returns with the liquidity of a public market. To do this, we have to stay focused on both the details of value creation, as well as the careful allocation of our capital." In practical terms, this means buying key parts-makers with exclusive products and many aftermarket sales. It means a "value-based operating methodology" (i.e., raising prices, of which more later), a lean, decentralized organization and, of course, generous helpings of debt.

Open

As to the last point, management told analysts in 2018 to expect leverage in the range of 5.0 to 6.5 times earnings before interest, taxes, depreciation and amortization. Anything less would be a sign of a pending acquisition or special dividend. Over the past 27 years, TransDigm has swallowed 85 companies, including, last year, Esterline Technologies Corp. at a price of $3.9 billion. In the past 12 months, stockholders have opened the mail to discover two special dividends in the grand total of $62.50 a share. In aggregate, the owners received $3.6 billion. The latest balance-sheet data, adjusted for the second payout, in January, show debt equivalent to 6.1 times Ebitda.

Once an acquisition is in the bag, TransDigm slashes research and development costs and raises prices, especially on products destined for the aftermarket. The strategy has drawn unwanted comparisons to Bausch Health Companies, Inc., the renamed Valeant Pharmaceuticals International (*Grant's*, March 7, 2014). Be that as it may, TransDigm's adjusted Ebitda margins of 45.9% put its rivals' in the shade: For instance, Hexcel Corp. at 24.3%, Heico Corp. at 26.5% and Woodward, Inc. at 17.8%. TransDigm's own customer, Boeing, earned just 12.6% in 2018, before 737 MAX-related losses. Excluding the acquisition of Esterline, on which management is now working its customary magic, Ebitda margins floated above 50% over the past 12 months.

Aggressive pricing accounts for more than a little of these disparities. In December, Capitol Forum published a before-and-after study of prices paid by the Defense Department for Esterline's sole-source parts. March, the month of the closing of the TransDigm acquisition, was the benchmark for comparisons. According to the analysis, such prices were 84.3% higher, on average, than the previous pre-acquisition price.

Mr. Market has raised no objections. From the March 14, 2006 initial public offering to year-end 2019, the stock generated a total return of 5,938.4% versus 232.4% for the S&P 500, both including reinvested dividends.

Goldman Sachs laid out the pre-virus bull case in February. Air traffic would grow at 5.5% per year, roughly twice the rate of global GDP. Though airlines would invest to meet this anticipated demand, the portion of the fleet aged five years or more would outgrow the overall fleet, so implying strong continued demand for aftermarket parts and thus strong organic growth for years to come.

Of course, Covid-19 furloughed that scenario, and TDG's share price has crashed to $336.65 from a Jan. 23 high of $657.93. Even so, the shares change hands in the non-bargain region of 25.7 times trailing earnings and 13.3 times enterprise value to Ebitda.

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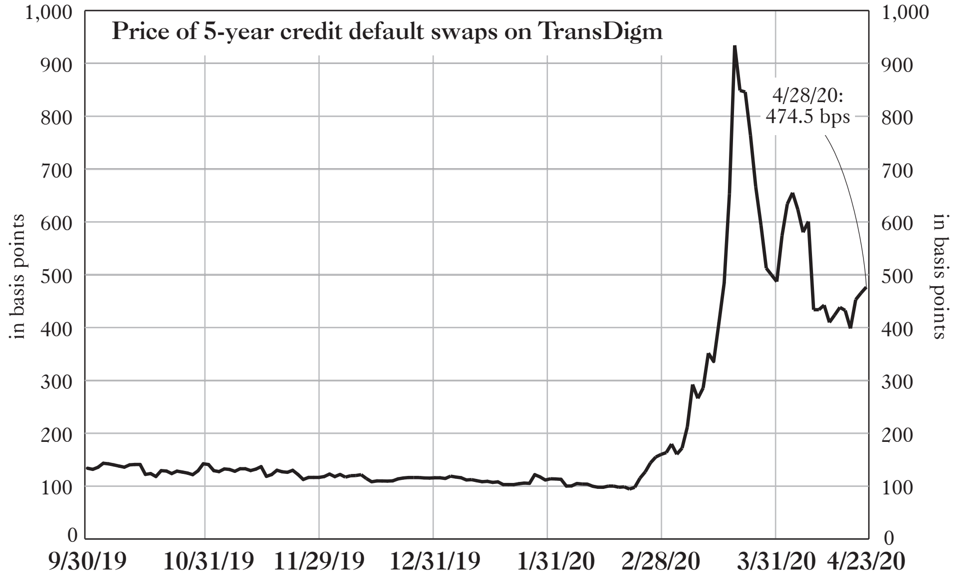
The grounding of the world's air fleet is the first arrow in the bears' quiver. Airlines are taking the opportunity afforded by commercial self-isolation to retire older, more maintenance-needy and less fuel-efficient jets. Thus, according to a March 30 *Business Insider* dispatch, American Airlines Group, Inc. plans to speed up the retirement of its 757-200 and 767-300ER fleets, KLM Royal Dutch Airlines its 747-400s, Virgin Atlantic Airways Ltd. its A340-600s, Delta Air Lines its MD-88s and MD-90s and so forth.

This represents a double blow for TransDigm. Aftermarket parts generate the aforequoted 52% of revenues, but some 75% of Ebitda, according to Goldman Sachs. The number of older planes in use is one source of these high-value sales; the number of miles that such aircraft fly is another. New planes under warranty are typically repaired with OEM parts, so the aftermarket business thrives on vintage jets. With the phasing out of senior planes, aftermarket demand will suffer a reset even when fleet utilization begins to increase. Besides, airlines can salvage parts from retired aircraft at a handsome savings to TransDigm's pricey wares.

The balance sheet is bearish arrow No. 2. Although leveraged at the aforementioned 6.1 times Ebitda, B-rated TransDigm chose not to draw down its $760 million revolver in March but rather tapped the credit markets for $1.1 billion of 8% secured notes due 2025 (as well as for a $400 million reopening of the 6¼ first-lien notes due 2026); the 8s change hands today at 103.76 for a yield-to-worst of 6.9%, or a 653 basis-point pickup to Treasurys. Compare and contrast the average single-B spread of 899 basis points.

Picture of credit risk



source: The Bloomberg

The reason for this particular funding path is simple enough. The bonds come largely without legal strictures, while the substantial drawdown of a revolving line of credit would commit TransDigm to a net debt ratio of no more than 7.25 times Ebitda. A drop in earnings of as little as 15.3% would trip that covenant.

Sky-high margins normally constitute a kind of protective insulation since efficient businesses can cover fixed costs in all but the most extreme conditions. TransDigm, however, is a special case, inasmuch as aftermarket parts, and the grounded airlines that formerly bought them, generate the bulk of its earnings.

In financial leverage, we come to arrow No. 3. In the 12 months ended Dec. 28, TransDigm's operating income covered interest expense by 2.2 times. And, thanks to the April bond sales, interest costs are set to rise even as operating income declines. For comparison, over the past 12 months, Heico, which carried net debt equal to 0.9 times Ebitda as of Jan. 31, covered its interest expense by 23.9 times.

The cost to insure TDG's debt with five-year credit default swaps stands at 474.5 basis points, down from 934 basis points on March 19 but up from 94.5 basis points on Feb. 20. (No CDS reference Heico, which funds itself with bank debt.)

Since the commercial world stopped turning, management has implemented one- to two-week furloughs at its factories, reduced headcount by 15% and docked the CEO's cash compensation by more than 50%. But there's a flip side to lean operations and very high Ebitda margins—there isn't much fat to cut.

TransDigm's aggressive pricing policies were raising eyebrows before Covid-19 came calling, which is arrow No. 4. On Feb. 25, 2019, the Defense Department's inspector general released a report on TransDigm's parts: Of 47 items reviewed, only one had cost the government's buyers less than 15% over the company's cost. Markups on the other 46 ranged from 17% to 4,451%. TransDigm refused cooperation in the case of 15 items, the IG said, though the company did make amends by writing a check to the government in the entirely manageable amount of $16.1 million.

But that gesture did not quite settle things. In an Oct. 29, 2019 letter to Congress, Ellen Lord, Under Secretary of Defense for Acquisition and Sustainment, said that the department was initiating an audit of TransDigm's "business model" and of all contracts the department signed with TransDigm between Jan. 1, 2017 and June 30, 2019. After the May hearing that led to TransDigm's remitting that refund check, the House Committee on Oversight and Government Reform started a probe of its own. Notably, TDG managed to unite the political oil and water of Alexandria Ocasio-Cortez (D., N.Y.) and House Freedom Caucus leaders

Mark Meadows (R., N.C.) and Jim Jordan (R., Ohio). Perhaps Nick Howley, the TransDigm chairman, will cop the Nobel Peace Prize.

To prevent the corporate hand from delving deeper into the taxpayer's pockets, Defense created a "Cadre of Pricing Experts" to take a fine-tooth comb to TransDigm's invoices, according to Lord's Oct. 29 letter.

"The Department is actively investigating potential reverse-engineering possibilities for over 1,000 sole source parts to create competitive alternatives and drive down prices for those parts," Lord wrote about TransDigm in response to questions from Charles Grassley (R., Iowa), chairman of the Senate Finance Committee, on Dec. 9.

Maybe it's jealousy, or perhaps a question of taste, but competing aerospace companies seem to want no part of the TDG business model. "We work very hard to have a buyer-friendly entrepreneurial culture whereby those folks really want to be part of Heico for the long term," Eric Mendelson, co-president of Heico, itself an aerospace acquirer, said on the Feb. 26 earnings call. "And it's not, if you will, a quick private-equity…drive/jack up the prices, and run out the door." Mendelson did not name the company, or companies, to which he was referring.

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In the course of my work, I have heard from competitors that OEMs now require change-of-control provisions in their supply contracts with vendors in order to protect themselves from the likely pricing consequences of a TransDigm acquisition. I've also heard from maintenance chiefs at U.S. airlines that TransDigm's aggressive pricing strategy has pushed carriers to use more repaired parts (known in the industry as DER parts, as they must be approved by a designated engineering representative of a civil aviation authority) and reverse-engineered aftermarket parts (or PMA parts, for the Parts Manufacturer Approval process of the Federal Aviation Administration).

Of the 16 analysts on the case, nine say buy and two say sell. Short interest foots to 6.9% of the float, but there are sellers who don't work on Wall Street. Corporate insiders in the year to date have dumped a net 157,508 shares for net proceeds of $97.9 million.

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