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TransDigm Group Inc: TDG

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Sector: Industrials
Industry: Aircraft Parts Manufacturing
Current Price: $233.76
Target Price: $160

Company Description:
TransDigm Group Incorporated is a designer, producer and supplier of engineered aircraft components for use on commercial and military aircraft in service. The company operate through three main segments including, Power and Control, Airframe, and Non-Aviation. Their largest customers include Boeing, Airbus, and the US military.

Short

Volume:	1.5 M
Market Cap:	12.6B
Gross Margin:	56%
Comp	24%
Net Debt/EBITDA:	6.6
Short interest:	15.8%

Thesis:

Since inception, TransDigm Group has perfected the strategy of debt fueled acquisitions followed by aggressive price increases, lay-offs, and avoiding cost transparency that ultimately inflated margins. Not only is their strategy unsustainable, but TransDigm is believed to be engaging in illegal business tactics to keep prices that, if publicized, could effectively bring their "value driving" strategy to an end.

Catalysts:

- **Investigation by government to find proof of shady/illegal business tactics**
- **Boeing, Airbus, and the Dept. of Defense's need for cost saving inhibits large price increase / possible margin compression**
- **Alternatives to their "proprietary" parts becoming available**

Unsustainable Strategy

TransDigm has been able to grow their gross margins consistently despite no organic growth in their core business; which is aftermarket parts mostly for commercial aviation. Their growth strategy is to acquire companies that produce aftermarket parts for aircraft, cut costs, and raise prices. TransDigm's integration strategy typically includes firing several employees then subsequently raising prices by 100% or more. They basically have cornered the market on aftermarket parts by acquiring companies with patents and taking advantage of the intellectual property. In the latest earnings call it seems as though CEO Walter Howley is bragging about the monopolistic activities he has been engaging in which is very unsettling. The flowing quote is directly from the latest earnings call transcript;

"*If you're a PE firm that is looking in a proprietary aerospace business and you're outbidding us, you got to be pretty worried, right, because the only way you're going to do that is to be making a higher bet on the margin improvement. And the other thing is a couple have started it and frankly, we bought them. Odyssey started a roll up and we bought it." – Walter Howley*

It is highly unlikely that TransDigm will be able to continue this strategy from a regulatory standpoint. These actions are monopolistic in nature which will eventually lead to regulatory scrutiny.
There are only so many aftermarket aircraft parts (commercial and military) and even less with intellectual protection which means less opportunities for M&A. They will not be able to sustain their typical strategy of acquisitions for growth but instead on organic growth which has ironically been declining.

Inability to Continue Price Gouging

TransDigm's largest customer is the Department of Defense followed by Boeing and Airbus. Even though margins have increased, the price of Transdigm's products will undoubtedly will be under pressure because the current regulatory environment involving aggressive price increases on products containing intellectual property protection, brought about by recent pricing disputes in the pharmaceutical industry, will most definitely reduce management's ability to continue raising prices especially on aftermarket parts supplied to the Department of Defense.

In a report by Citron Research released on January 20th, Citron analysts dug through a leading defense parts and logistics management system and found some of the parts being sold under TransDigm and their prices pre and post-acquisition. The percentage increase in the prices of these items ranged from a low of 100% to a high of 736%.

Given the fact that President Trump was able to successfully negotiate the price reduction of Air Force One with Boeing and the F-35 program with Lockheed Martin, it is reasonable to assume that Boeing will pressure its suppliers to lower prices to reduce their production cost which should put more pressure on the price TransDigm's commercial products

Donald Trump has vowed to make government more efficient which means it is likely that TransDigm could be in his crosshairs soon. According to the report by Citron Research, the Department of Defense had already launched an investigation into TransDigm in 2008 for the same reasons but no action was taken then but it is

clear that Trump can and will. Recently, Democratic Congressmen from California, Rohit Khanna, called for another investigation into TransDigm's business practices. Their military segment has grown to 55% of total sales and I do not see that as a coincidence. The government and their frivolous spending habits make them the perfect customer to continue to raise prices which is why I believe CEO, Walter Howley, has targeted military aircraft parts suppliers as their M&A targets to take advantage of the obvious ability to overcharge the government.

Illegal Business Tactics!

The strategy used by Howley to circumvent the fair bidding process of the US Government involves selling through twelve subsidiaries that lie about their relationship with TransDigm to prevent bulk orders which would save the government money and reduce TransDigm's margins. According to research done by Citron, Bratenahl Capital Partners is a private equity firm founded in 2003 by Nick Howley, CEO Walter Howley's son, of which Walter is on the board of. The research states that Nick was born in November of 1982 which would make him 21 and still attending university at that time. Also, there are only 2 investors in Bratenahl one of which is called W.N.H., LLC which could very likely stand for Walter Nicholas Howley.

The evidence is strong that Walter could be the real owner behind this specific subsidiary which could prove that they are using illegal tactics. As more evidence comes to light the government will be able to build a case and request information which Walter is avoiding giving to the public (ie. Cost breakdown, distribution strategies, subsidiaries) and not only might that cause the government to cancel their contracts, which they can do at any time, but would cause them to go into bankruptcy within a year or two!

Over Levered

Howley's strategy consists of highly leveraging the company in order to complete these acquisitions and share repurchases which isn't sustainable in this rising interest rate environment. TransDigm currently has **$10.6** Billion in long term debt, which is over 90% of total debt outstanding, with December 2016 EBITDA of **$1,701.7** bringing their Net Debt/ EBITDA to a historical high of 6.6. Not only is debt outgrowing earnings, but the majority of their outstanding debt (59%) is variable rate.

If TransDigm is not able to continue finding new M&A opportunities, loses their ability to aggressively raise prices, or lose a government contract their liquidity and solvency will be called into question as its current assets only cover current liabilities three times. Also, they barely have enough cash to cover current liabilities. As time goes on, there is a greater possibility of default on current obligations. The credit rating agencies know this as well which explains why some of their debt is rated CCC+ (Junk).

Shady Management:

Going through TransDigm's last earnings call transcript I noticed that Walter Howley could offer little guidance for the next quarter, full year, or about current industry trends. It seemed as though he knew nothing about his own industry given the fact that he said, "I don't know" over 15 times to questions asked by analysts and the ones he did answer he gave a vague answer. He couldn't even offer an explanation to why the acquisitions he recently made were skewed towards military parts. Not only does the CEO not divulge any useful information but apparently, according to an audit report, it is company policy not to disclose any cost breakdown of their products. It is difficult to trust a CEO, let alone a company, when they refuse to be transparent and it baffles me that investors are still flooding into their stock.

The primary form of compensation TransDigm uses is restricted stock options that pay out when management reaches high EPS goals of which the executives have taken full advantage of by taking on excessive risk. Typically, stock options are used to align the interest of shareholders and management and you could make that argument here but when management is using unsustainable and possibly illegal business practices to boost margins you have to question their motives especially when TransDigm's CEO has taken home over $275 million in the past 5 years which makes him once of the highest paid CEO's is the U.S.

Why Has This Gone Unnoticed?

TransDigm would seem an investors best friend as it frequently repurchases shares and pays out substantial dividends to its shareholders. Or you could say that TransDigm is paying off its shareholders to not ask any questions which is what I believe since Mr. Howley doesn't answer questions anyway. Its easy for shareholders to look the other way when a company has paid out over $4.6 Billion in dividends since 2013. It is also very difficult to maintain a short position when the company engages is massive debt fueled share repurchases. The ride up has been very profitable for investors but once TransDigm's "value driving" strategy drives them into bankruptcy then the ride back can be equally as entertaining and profitable too… if you are on the right side.

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