A Perspective on TransDigm Group

Analyst Corner

By David Perkins, CFA

TransDigm (TDG) develops, manufactures and sells niche aerospace components, including valves, pumps, sensors, motors, batteries, faucets, seatbelts and latching systems for commercial and military aircraft. The company's product line-up is proprietary, vast (tens of thousands of SKUs) and diverse (50+ product lines). Its products are installed on almost all of the major commercial platforms currently in production globally, with an estimated installed base of over 70,000 commercial transport, regional transport, military and general aviation fixed wing turbine and rotary wing aircraft. TransDigm generates the bulk of its profits from selling replacement, or "aftermarket," components.

Firmly Entrenched

Roughly three quarters of TransDigm's sales come from products where it is the sole-source supplier (i.e. no current substitute exists). All parts on a commercial aircraft require Federal Aviation Administration (FAA) certification, which is an expensive and time consuming process for original equipment manufacturers (OEMs). As a result, aircraft manufacturers typically look to design in and qualify only one supplier per component on new aircraft, particularly for lower priced, less critical parts (the average price of TransDigm's products is a couple hundred dollars per unit). Once an aircraft is in use, airlines and other users are unlikely (and in many cases unable) to swap to an alternate supplier for replacement parts due to a combination of the potential cost of recertification, safety concerns and the hassle involved in attempting to save money on a negligible portion of operating costs. This relatively unique market structure creates durable, annuity-like income streams for TransDigm, as many aircraft platforms are produced for 20-30 years and flown heavily for a decade or more after production has ended. Time is a friend of the TransDigm owner.

Tailwinds

The popularity of air travel continues to grow. Revenue passenger miles (RPMs) are an industry measure of traffic that adjusts for changes in the size of aircraft and/or distance traveled per flight segment. RPMs have historically been the best predictor of commercial aftermarket demand, which together with the defense aftermarket drives roughly 80% of TransDigm's profits. Growth in RPMs over the last 40 years has been very consistent (5-6% annually), with only three brief and relatively modest periods of decline (the early '90s, post 9/11 and during the Great Recession of '08/'09). Each year, Boeing publishes a long-term forecast of industry growth based upon its order flow, recent global traffic patterns and general economic conditions. In its most recent forecast published this past June, Boeing called for 5% annual passenger and cargo traffic growth over the next 20 years. While there will inevitably be periods of faster and slower growth along the way, our work also suggests a steady, upward trajectory in passenger traffic going forward.

Another pillar of TransDigm's business has been its ability to consistently raise prices at rates exceeding inflation. On average over the last 20 years, we estimate TransDigm has realized a roughly 5% annual increase in the selling price of its components. Importantly, pricing gains have been relatively uniform across its portfolio over time. TDG's biggest selling SKU is less than 1% of total sales, so no single product or group of products is responsible for the increase. We think TransDigm's demonstrated ability to increase prices will continue, and believe the combination of rising traffic and price in TDG's core commercial aftermarket business will continue to generate attractive organic growth well into the future.

Helicopter Ben? We Prefer Airplane Nick

We have a lot of respect for TransDigm's co-founder, Chairman and CEO Nick Howley. He and the board have instilled an ownership culture and maintained and executed a disciplined acquisition strategy that has created significant wealth for shareholders. TransDigm's business generates prodigious excess cash flow, which management has deployed principally in two ways: 1) through the purchase of additional "proprietary aerospace businesses with significant aftermarket content," or 2) via the payment of special dividends to its owners. TDG has largely pursued the latter course when it has been unable to find acquisitions that clear its stringent qualitative and financial hurdles, and has paid a total of $42.50 per share in special dividends over the past 5 years.

We like lumpy, opportunistic M&A stories led by operationally and financially savvy management teams, as few hitters see six or seven consecutive batting practice fastballs. When TransDigm came public in 2006, 90% of sales came from proprietary products and 75% came from components with sole-source positioning. Fast forwarding 7 years and 29 acquisitions later, those two key variables remain unchanged. You won't find "de-worsification" at TransDigm. As well, we estimate management has earned in the neighborhood of 15% after-tax returns on the roughly $2.7 billion of capital it has deployed over that time frame, handily exceeding its cost of capital. Looking forward, TransDigm still has significant opportunity to continue to acquire high quality, niche aftermarket aerospace platforms. In the event it cannot, TDG's stated intention is to continue to stamp out solid organic growth, re-lever its balance sheet, and return excess cash flow to shareholders with a goal of producing mid-teens annual total returns. We are pleased to own this very attractive business, managed by a high caliber team, at a healthy discount to our $175-$180 value estimate.

David Perkins, CFA, joined Weitz in January 2004. He graduated from Taylor University in Upland, IN and previously spent three years as an equity analyst with McCarthy Group Asset Management. Dave has been a CFA charterholder since 2009.

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