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Geoff Gannon's notes on Honeywell's planned spin-off of Resideo Technologies

- October 10th, 2017: Honeywell announced intention to spin-off Honeywell Homes and ADI global distribution business
- Honeywell Homes
    - Has roots dating back to the 1885 invention of the thermostat
    - HVAC controls
    - Long-term license for the "Honeywell Homes" trademark
- ADI distribution
    - Security
    - Fire protection
- Resideo
    - $4.5 billion in sales (2017)
    - Global leader in PROFESSIONALLY INSTALLED RESIDENTIAL comfort and security
        - Note: "Professionally installed"
        - Note: "Residential"
        - Most of Honeywell Home's sales are through professional installation done in homes
    - Honeywell brand is in more than 150 million homes
    - Honeywell branded products are installed in more than 15 million homes per year
        - Note: 150 million / 15 million a year = 10 years; these are long-lived products
    - Decision makers = "dealers" and "installers"
    - One-third of products are "connected devices"
    - Customers
        - Professional contractors
        - Service provider partners (example: "ADT")

        - Do-it-yourself (example: homeowner)
- Spin-off will be tax free
    - Note: This means Resideo will NOT be acquired within 2 years of the spin-off
- No industry data in the SEC filing I'm referring to was "specifically commissioned" for Resideo / Honeywell
- Resideo is made up of
    - Honeywell Home's "Products" business
    - ADI Global Distribution
- Honeywell Home's "Products" business is made up of
        - Honeywell Home's "Comfort & Care"
            - Note: Overwhelmingly "Comfort" and a little bit "Care"
        - Safety & Security Products
            - Note: Some of these are sold through ADI distribution
    - Honeywell Home ("Products") serves mostly RESIDENTIAL end markets
    - ADI global distribution ("Distribution") serves mostly NON-RESIDENTAL end markets
- Usual spin-off language of "substantial indebtedness"
- What does that mean here?
- Reisdeo will have $1.23 billion in debt
    - Will make a $1.23 billion payment to Honeywell
- Also: Reisdeo will take on ANUALLY CAPPED environmental liabilities
- Usual language of "certain of Honeywell's environmental related liabilities"
- However, knowing Honeywell's history I expect these liabilities to be BIG to HUGE
- For example: Honeywell is a 100+ year-old U.S. manufacturer
- It has roots (Resideo will be headquartered in Morris Plains) in NEW JERSEY
- All signs point to Honeywell being the kind of company with unbelievably large future obligations to clean up toxic waste sites, pay lawsuits related to past environmental issues, etc.
- I believe a major reason for Honeywell spinning off Resideo is:
    - Getting a $1.23 billion payment from Reisdeo, AND
    - Off-loading $140 million a year in annual environmental costs
- Note: if environmental costs are truly perpetual, $140 million a year is MORE of an obligation than $1.23 billion in new debt
- They aren't put on the balance sheet as if they're truly perpetual, but an investor like me MIGHT want to assume Resideo will, in fact, pay $140 million a year in cash FOREVER (we know the situation won't be worse than $140 million a year as long as Honeywell – the parent – stays solvent)
- Resideo discusses the environmental obligations in depth later in the filing
- So what sort of stuff does Honeywell Home actually make?
- What does of stuff does ADI actually distribute?

- ADI
    - Fire
    - Safety
    - Intrusion
    - Video surveillance and
    - Access controls
- Honeywell Home
    - Security panel
    - Interior and exterior camera
    - Indoor and outdoor motion detection
    - Sound detection
    - Thermostat
    - Heating control
    - Smoke detection
    - Glass break detection
    - Whole house humidifiers
    - Whole house de-humidifiers
    - Water filters
    - Air quality systems
    - Furnace and boiler controls
    - Water leak detection
    - Freeze detection and
    - Water heater controls
- ADI
    - 4.7 million connected customers
    - 200+ stocking locations
    - 100,000+ contractors as customers
- Corporate history
    - Honeywell Home dates back to 1885 invention of the electric thermostat
        - Honeywell was formed through a series of mergers from 1885-1927
            - Most people trace the earliest origin of the post 1927 Honeywell to the 1885 invention of the thermostat by one of the companies Honeywell eventually merged with
            - Honeywell was actually named after "Mark Honeywell" who did not found a company with the name Honeywell till 1906
            - However, key parts of the company named Honeywell actually date back to companies founded in the late 1800s and early 1900s that were then acquired by Honeywell before 1927
            - Basically, Honeywell's thermostat product business is THE OLDEST BUSINESS it owns

            - So: Honeywell is spinning off "the original Honeywell" here
    - ADI
        - Originally called "ADEMCO" distribution
            - There are other companies called "ADEMCO" that may be disposed operations of the U.S. ADEMCO that became ADI
                - For example: ADEMCO in Singapore is a disposed business of the U.S. ADEMCO
            - It sounds like ADEMCO had trouble expanding into the far east in the late 1970s and a man they hired to help them expand in the region instead eventually offered to buy their far east operations from them
        - Note: ADI is called ADI "global distribution", but this is a misnomer. ADI is much, much bigger in the U.S. than it is in other countries
        - ADEMCO was Renamed "ADI" in 1987
        - ADI was Acquired by Honeywell in 2000
    - In 2000: ADI was part of Pittway
        - Pittway had $1.3 billion of sales in 1998
        - Pittway expected $1.6 billion of sales in 1999
        - Pittway had 120 distribution outlets at the time of the deal
        - Honeywell paid $2.2 billion for Pittway (including $167 million in assumed debt)
        - So, Honeywell paid between 1.38 and 1.69 times sales for Pittway
            - However: Pittway was both a MAKER and distributer of fire and security products
                - This makes a Price-to-sales multiple calculation difficult
            - For example: manufacturers like Honeywell "Products" and George Risk (RSKIA) that sell through ADI today have gross margins of around 50% while ADI itself has gross margins around 17%. Operating margins may be 3 times higher per dollar of sales at a manufacturer of fire and security products than at a distributor. So, it's difficult to know what kind of multiple is really being paid on sales unless you separate manufacturer sales from distributor sales
        - At the time of the Pittway deal, Honeywell Home had $3.4 billion in sales
        - This suggests that neither Honeywell Home nor ADI are much different in size than they were 18 years ago
        - ADI has 200 stocking locations now (it's in more foreign countries)

As a check on this, let's look at George Risk's 1999 sales and ADI's share of those sales vs. George Risk's 2017 sales and ADI's share of those

- In 1999, George Risk had sales of $13.49 million and
- ADI bought 38% of George Risk's output for $5.13 million
- In 2017, George Risk had sales of $11.93 million and
- ADI bought 34.6% of George Risk's output for $4.12 million
- It is more likely that George Risk / ADI have the same market share and that the market for burglar alarms in the U.S. is about 20% lower in nominal terms than it was 18 years ago than it is to assume George Risk and ADI have 0.8 times the market share they once did
- In other words: The U.S. market for distribution of fire and security is
  - Not a growth market over the last 20 years (it hasn't keep pace with inflation) and
  - At a cyclically lower point today than it was in 1999
- We don't have any evidence that Resideo (either Honeywell Home or ADI) is really much bigger today than it was 20 years ago
- It's possible the businesses that make up Resideo have SHRUNK in REAL TERMS over the last 20 years

- ADI after it was acquired by Honeywell
  - Hit 100 branches in North America in 2014
  - Introduced private label products in 2014
  - As of 2016, now claims it has the highest market share of any distributor of security and low voltage products in both North America and Europe, Middle East, and Africa (EMEA)
  - Some side notes on this…
    - ADI already had the biggest share in North America before 2016
    - So, ADI achieved the highest market share in EMEA in 2016
    - But, the whole "Americas" and "EMEA" thing is VERY misleading
      - Europe makes up most of the EMEA market for security and low voltage products
      - The U.S. makes up BY FAR the biggest part (think like 90%+) of ADI's "Americas" business and therefore also it's "North America" business
      - In other words: ADI has the #1 market share for the distribution of security and low voltage products in
        - The United States and
        - Europe
  - As investors looking at Resideo: we shouldn't give a second of thought to ADI's business outside of the U.S. and Europe, because ADI's profits are a small part of Resideo's profits (Honeywell Home makes more money) and ADI's business outside of the U.S. and Europe is a small part of ADI's sales and may contribute an even smaller (perhaps ZERO) amount of profit

- Therefore: it is best to think of Resideo as:
  - Honeywell Home (“Products”)
  - And ADI (“Distribution”) in the U.S. and Europe only
    - Never forget: Resideo is mostly an American company
- Honeywell Home will pay royalties to Honeywell for a 40-year license for the “Honeywell Home” brand. Use of the “Honeywell” name alone is specifically forbidden. There will be a grace period during the transition where the Honeywell name alone may appear on Resideo products.
- ADI has a customer base of about 100,000 professional contractors
- ADI is an important sales channel for Honeywell security products
- However, the vast majority of ADI’s sales are for non-Honeywell products
- Honeywell Home (“Products”)
  - $2.38 billion in sales during 2017
    - $337 million (14% of sales) were made to ADI
      - Net sales (to external customers) were $2.04 billion
- Honeywell Home makes devices that
  - Monitor or control
    - Air conditioners
    - Water heaters
    - Boilers
    - Furnaces
    - Whole home humidifiers
    - Whole home de-humidifiers
    - Patient health data (for in-house medical supervision)
    - Burglar alarms and
    - Carbon monoxide alarms
- Geographic Breakdown
  - By sales for all of Resideo
    - North & South America: 68%
    - Europe, Middle East, and Africa: 29%
    - Other: 3%
- Product category breakdown
  - Comfort: 66%
  - Security: 34%
- Product connection breakdown
  - Not connected: 63%
  - Connected: 37%
- ADI Distribution
  - End market breakdown
    - One-third residential

        - Two-thirds non-residential
    - Geographic Breakdown
        - North & South America: 81%
        - Europe, Middle East, and Africa: 17%
        - Other: 2%
- ADI's historical market leadership
    - Roots date back to 1929 involvement with WIRED burglar alarm systems
    - 1980s: Introduced first "reliable" wireless security system
    - First company to introduce professionally monitored home smoke and carbon dioxide detection systems
    - First company to widely deploy an alarm platform with:
        - Cloud services
        - Mobile app
- Market position of Resideo overall
    - Management claims
        - #1 global market share in thermostats
        - #1 global market share in security products manufacturing
        - #1 global market share in home security products distribution
- Competes on the basis of
    - Reliability
    - Ease of use
    - Trusted by installers
- Resideo has 1,300 engineers in
    - Atlanta, Georgia and
    - Two sites in India
- ADI product breadth
    - Buys
        - 350,000 products
        - From 1,000 manufacturers
    - Sells
        - 350,000 products
        - To 100,000 contractors
    - Through
        - 200 stocking locations
        - 1,000 sales reps
        - And a website (17% of ADI's sales)
- ADI sales grew 4% a year over the last 4 years
- Cap-ex is 1.3% of total sales at ADI
- Connected devices
    - Sells "LYRIC" family of connected devices

- Devices often work with
    - Amazon
    - Apple
    - Google and
    - Samsung
- Resideo also sells some software
  - Software-as-a-service
  - Platform-as-a-service
  - Data-as-a-service
- Customers for this fee-based software stuff includes
  - Security companies using Resideo's data to do remote diagnosis of problems and preventative maintenance of problems to reduce the need for in-person service visits by a technician or to increase the likelihood the technician can resolve the problem with only one visit
  - Health care companies using Resideo's patient health data to remotely monitor a patient's health and reduce the probability of re-admittance to the hospital
- ADI has 18% market share in India
- ADI plans to "selectively pursue" acquisitions in
  - "High growth regions" (like India) and
  - "Connected devices"
- Cyclicality of end markets
  - U.S. residential investment is at 87% of its long-term trend from 1960-2017
  - In plain English: "Normal" spending on Honeywell Home Products is probably 15% higher than last year's spending. So, "Products" normal sales level is 1.15x last year's sales level
- Resideo will be
  - Headquartered in Morris Plains, New Jersey
    - No change here
    - In the late 1990s, GE was going to buy Honeywell
    - Instead, Allied Signal acquired Honeywell
      - And adopted the Honeywell name instead of Allied Signal
    - Allied Signal was a New Jersey company (Honeywell was a Minnesota company)
  - A Delaware Corporation
    - Also not a change
    - Honeywell is incorporated in Delaware
- To review the corporate history here for a second
  - Resideo will be a combination of parts of what was originally
    - Honeywell
    - Pittway

- Resideo has never existed as RESIDEO inside Honeywell, for example:
    - ADI was never combined with Honeywell Home inside Honeywell
    - Each of Honeywell's business units send cash DAILY to Honeywell HQ
- Risks
    - Overpaying for acquisitions
    - Especially in
        - High growth countries
        - Connected devices
    - "Substantial indebtedness"
        - $1.23 billion of debt
        - And a requirement to pay $140 million a year in cash for annual environmental charges
    - "Excessive competition" in high growth regions
    - "Excessive competition" in connected devices
    - Pretty common sight
        - Leader in a no-growth market with limited competition
        - Wants to acquire, invest, etc. its way to growth in a high-growth and high competition market
        - Creates a risk of bad capital allocation as free cash flow from the durable, wide moat business that's been around forever is milked to invest in a less durable, or less wide moat new business.
    - Honeywell expects to pay a dividend
        - Bad idea
            - They have $1.23 billion in debt (something like 3x EBITDA)
            - On top of a fixed-charge of $140 million a year (for environmental liabilities)
            - Plus: they want to acquire things
        - This could leave them
            - Reluctant to buy back a lot of stock
            - Willing to pile up too much debt
            - Or willing to issue shares to acquire other businesses
- "Bad omens" found in the filing
    - "In recent years, this trend of CONSOLIDATION has accelerated and many of our customers have combined with companies with whom we have LITTLE OR NO PRIOR RELATIONSHIP."
    - Mention of "EXCESSIVE competition" in high growth regions
    - Mention of "EXCESSIVE competition" in connected devices
- Really "Out There" macro type concerns hinted at in the filing
    - Collapse of NAFTA would hurt Honeywell

        - U.S. manufacturers often make use of assembly type manufacturing work on the other side of the U.S.-Mexican border. A lot of Honeywell's "Products" business fits the general kind of product economics where it makes sense to outsource part of the manufacturing process (basically, assembly) of certain high volume products. Some of Honeywell's products business is basically a "parts" business and because Mexico is so close to the U.S. it doesn't create logistical problems to assemble these parts in Mexico. However, it would create problems if you tried to off shore this work. So, this is the kind of stuff you'd potentially move back to the U.S. For example, we know competitors of George Risk (a supplier to ADI) tried to offshore manufacturing and this turned out badly for them versus George Risk which kept all operations in Nebraska.
    - Global warming might hurt Honeywell
        - Most companies mention global warming and in almost all cases it's a silly risk to mention. For example, if global warming increases the risk of hurricanes, premiums for catastrophic risk insurance will go up. It's not a business killing long-term risk to write hurricane insurance even if global warming causes many, many more severe hurricanes. But, Honeywell is in an unusual position. Honeywell's "comfort" business (which is its biggest source of profits) depends on having BOTH hot summers and cold winters in the United States. In fact, I would guess that more than 50% of Resideo's profits come from the fact that most of the United States experiences BOTH hot summers and cold winters. If temperatures became more mild (colder in the summer and/or hotter in the winter) this would permanently reduce the need for many of the products Honeywell makes.
- At this time: I don't think the U.S. trade policy concerns or U.S. climate concerns would make me adjust my appraisal of Resideo. However, unlike many risks you find in 10-Ks: these two risks are legitimate long-term concerns. Climate change could be either a plus or minus for Resideo depending on how the climate changes. Hotter summers and colder winters are good. Cooler summers and warmer winters are bad. Resideo benefits from the existence of NAFTA.
- How much does Resideo depend on the U.S.
    - U.S. sales: 68%
    - International: 32%
- "Increasingly, our manufacturers are combining, leaving us with fewer alternative sources."
- ADI has some sole source suppliers. We know George Risk signed a non-exclusive supply agreement with ADI. I've read the agreement (there are some confidential terms that have been redacted for the filing) and nothing in the agreement is really favorable to

ADI (despite ADI buying about one-third of everything George Risk makes) except for George Risk having to give ADI written warning of an upcoming price increase. This suggests ADI asked for such an agreement simply to be assured they would know about price increases far enough in advance in the future.

- "A substantial volume of our Comfort & Care products benefit from the favorable tariff rates established under the North American Free Trade Agreement (NAFTA)"
- OEM customers
    - This would include companies like:
        - A.O. Smith (water heaters)
        - ADT (security systems) and
        - Carrier (air conditioners)
    - It's difficult to get new OEM customers because they require
        - Qualification and inspection of
            - Engineering
            - Documentation
            - Manufacturing and
            - Quality control
        - Before placing volume orders with Honeywell Home
- "By virtue of our largest customers' size and the significant portion of revenue that we derive from them, they are able to exert significant influence in the negotiation of our commercial agreements and the conduct of our business with them…the success of our business depends on OEMs continuing to outsource the manufacturing of critical products to us…We have in the past LOST BUSINESS from OEM customers who have taken the manufacturing of our products in-house or given market share to our competitors".
    - It's hard to know how to read this section of the filing. Honeywell Home has obviously lost OEM business before. And they rely on a few OEM customers for a large part of their revenue (and an even larger part of Resideo's overall profit). However, some of the points made about bargaining power, etc. don't match well with information we have on Honeywell Home's gross margins, returns on tangible capital, etc. Honeywell Home's margins, returns on capital, etc. are all very high. None of that matches up well with a company that manufactures for OEMs who have far more bargaining power than they do. On the other hand, that kind of financial data can match up with a company that hasn't grown its market share, size in real dollars, size in nominal dollars, etc. much – or at all – in 20 years.
- Side note: Resideo makes mention at times of a concern I have with Honeywell Home operating outside the U.S. Some of the high growth regions that Honeywell Home hopes to expand into are risky places for intellectual property. Historically, U.S. "home comfort" companies like Honeywell, A.O. Smith, Carrier, etc. have depended really

heavily on intellectual property rights to gain an earlier lead in certain markets that proved durable for decades or even a century. It's probably not a good idea for these companies to manufacture anything in countries like China. A.O. Smith has been in China for 20 years. Their sales come overwhelmingly from the combination of the U.S. and China. They are the leader in the U.S. and probably "a leader" in China. If you look at A.O. Smith's stock (up 22% a year over the last 5 years), the move into China has definitely paid off for them. However, long-term this creates the possibility of creating a foreign competitor. I don't know how much this matters due to the difficulty of import competition in these industries. Nonetheless, I think we should assume it would be expensive and impractical for Resideo to enforce its intellectual property rights in emerging markets the way it had historically in the U.S.

  - Resideo has over 3,000 patents

- Environmental liabilities
- Resideo will make cash payments to Honeywell of 90% of amounts billed including
  - Environmental claims
  - Remediation
  - Hazardous exposure
  - Toxic tort claims (that is, lawsuits)
- These amounts will be net of insurance proceeds (in other words: Honeywell's annual expense less Honeywell's insurance process time 0.9 equals amount Resideo pays Honeywell)
- However: Resideo's environmental payments to Honeywell will be capped at $140 million per year
- Payments will be made quarterly in equal amounts for the prior year's expense
  - In other words, if Honeywell has $200 million of expense ($200 million * 0.9 = $180 million; $180 million > $140 million) this will be capped at $140 million and then paid in 4 equal quarterly installments of $35 million.
- We should assume Resideo will pay Honeywell $35 million a quarter ($140 million a year), because
  - Such claims amounted to
    - $259 million in 2015
    - $221 million in 2016
    - $200 million in 2017
  - And insurance proceeds were inconsequential ($2 million to $18 million)
- Clean-up sites
  - The agreement between Resideo and Honeywell relates to
    - 230 sites OR GROUPS OF SITES that are undergoing environmental remediation under U.S. federal or state law
  - Side note: There are a large number of such sites in places where Honeywell had legacy businesses such as New Jersey

- How do we value this obligation?
    - Most conservative way to do it
        - Lower after-tax FCF by $140 million a year FOREVER
            - Why?
                - Payments to Honeywell from Resideo to cover environmental liabilities are NOT tax deductible
            - And
                - Assumptions for environmental liabilities as shown on a company's balance sheet are often unreliable
            - Therefore: we know the annual cash payment is always capped at $140 million. So, reducing FCF by $140 million a year forever can't be LESS CONSERVATIVE than the actual outcome. In other words, we can use the "worst case scenario"
            - What really is the worst case scenario?
                - Honeywell goes bankrupt
                    - Moody's rates Honeywell in the middle of the investment grade range
- Obligations
    - Must pay Honeywell royalties through 2058 or 2059 for use of the Honeywell Home trademark; will lose use of the Honeywell Home trademark after 2058 or 2059
    - Will have $1.23 billion in debt at the time of the spin-off
    - Must make payments to Honeywell of up to $140 million a year for environmental clean-up and related costs
- "Anticipate paying cash dividend on our common stock"
- Resideo had 3-year average adjusted EBITDA of $556 million
- Resideo will make payments of up to $140 million a year to Honeywell for environmental liabilities
    - However, these liabilities will not be tax deductible
- Therefore, DO NOT assume Resideo's EBITDA is really any greater than about $400 million for appraisal purposes
- The company will have $1.23 billion in debt
- So, Debt/EBITDA is $1.23 billion / $400 million = 3.08 times
- Assume Debt/EBITDA of 3
- A normal price for a U.S. company under the new corporate tax rate is probably 9-10x EBITDA
- So, 10-3 = 7 or 10-4 = 6. The equity in this company might be valued at 6-7 times EBITDA
- EBITDA might be $400 million
- So, the market cap of this spin-off might be $2.4 billion to $2.8 billion.
- Can we do a free cash flow based appraisal?

    - No. Honeywell operates by having all business units send cash to headquarters DAILY. This, combined with some other facts about this spin-off mean I don't have any confidence in us creating a clean estimate of historical free cash flow at these businesses.
- Could the equity value of Resideo actually be much greater than $2.8 billion?
    - Yes.
        - It depends on the environmental obligations. Resideo estimated – as of June 30th, 2018 – that these obligations would be carried at $588 million. That's not very large compared to a perpetual payment of $140 million. For example: $588 million / $140 million = 4.2 years. And a stream of cash outflows lasting 4 years is very different than one lasting FOREVER. But, the actual obligation is written such that it could basically last forever. To be free from the obligation entirely, Resideo must make payments of less than $25 million a year for 3 consecutive years to Honeywell. Then, the agreement will be terminated. But, there's no other way for Resideo to be free from this obligation. So, we could assume the liabilities knock a value off Resideo of anywhere BETWEEN
            - $140 million a year FOREVER
            - And $588 million
                - How big of a difference does this make?
                    - I'd guess the difference is about $1.5 billion
                        - This is $140 million in NON-tax deductible CASH payments times 15 (the market often values stocks around 15x free cash flow) = $2.1 billion versus the balance sheet amount of a $588 million obligation
- So, Resideo's market cap could be anywhere from $2.4 billion to about $4.2 billion, depending on what environmental liabilities assumptions you make and what EBITDA multiple you put on the stock.
- At a market cap of $2.4 billion, I might be interested in the stock.
- At a market cap of $4.2 billion, I'd definitely not be interested in the stock.
- For debt, Resideo assumes a 6.2% interest rate
- "We have longstanding relationships with important OEMs and service providers such as ADT, United Technologies (United Technologies acquired Carrier in 1979), and A.O. Smith"
- "A number of these relationships extend more than 25 years, including some spanning 40 years or more"
- Properties
    - Resideo doesn't disclose which properties it owns and which it leases
    - We know it owns some

        - In the "Americas" Resideo has
            - 8 manufacturing sites
            - 115 stocking locations
            - A warehouse
            - And 12 other buildings used as offices, labs, or engineering sites
    - Resideo also leases or sub-leases some sites from Honeywell and Honeywell leases or sub-leases some sites from Resideo
        - These numbers aren't big
        - But the exact language used suggests again that both Resideo and Honeywell actually OWN some of these sites (they don't lease everything)
            - How do we know this?
                - The language "lease or sub-lease" would instead just be "sub-lease" if all locations were leased
                - And the language "own or lease" would instead just be "lease"
- Gross profit
    - "Products" gross margin: 51%
    - "Distribution" gross margin: 17%
        - Sales of products and distribution are roughly equal, so
        - 51% / 17% = 3
        - Honeywell Home accounts for 3 times as much gross profit as ADI
        - Resideo gross profit breakdown
            - Honeywell Home: 75%
            - ADI distribution: 25%
- Operating profit
    - Products ("Honeywell Home")
        - $367 million in 2015
        - $426 million in 2016
        - $353 million in 207
        - 3-year average: $382 million
    - Distribution ("ADI")
        - $77 million in 2015
        - $104 million in 2016
        - $131 million in 2017
        - 3-year average: $104 million
    - Operating profit breakdown
        - Honeywell Home products: $382 million
        - ADI distribution: $104 million
        - $382 million / ($382 million + $104 million) = 79%

        - $104 million / ($104 million + $382 million) = 21%
- How much more does “Honeywell Home” matter to Resideo than ADI
    - Sales: Honeywell Home and ADI have the same sales (1 to 1)
    - Gross profit: Honeywell Home has 3 times the gross profit of ADI
    - Operating profit: Honeywell Home has 4 times the operating profit of ADI
- Resideo’s total value MAY be skewed as far as
    - 80% of value comes from Honeywell Home products business
    - 20% of value comes from ADI distribution business
- What might Resideo’s free cash flow look like?
    - “Historically, we have generated positive cash flow from operations”
    - “We expect capital expenditures for full year 2018 to be approximately $40 million”
    - Assume adjusted EBITDA equals $400 million (after environmental payments)
    - Assume EBITDA – Cap-ex equals pre-tax free cash flow of about $360 million
    - Assume debt of $1.23 billion has an interest cost of 6% a year equals $73.8 million
        - $360 million minus $73.8 million equals $286.2 million
    - Assume a corporate tax rate of 21%
        - $286.2 million times 0.21 equals $60 million
    - Assume the $140 million in environmental payments is also taxed at 21%
        - $140 million times 0.21 equals $29.4 million
    - $60 million plus $29.4 million equals $89.4 million
    - Round up to $90 million in annual taxes
        - Possible free cash flow calculation (VERY unreliable)
            - $400 million+ in EBITDA
                - Minus $40 million in capital spending
                    - Leaves $360 million in cash flow before interest and taxes
                        - Minus $75 million in interest
                            - Is $285 million in pre-tax income
                                - Minus $90 million in taxes
                                - Is $195 million in after-tax income
    - Basically, “owner’s earnings” / free cash flow etc. on LEVERAGED basis might be around $200 million or so
    - What if Resideo stock is valued at a “normal” FCF multiple of something like 15
        - $200 million * 15 = $3 billion
        - Resideo’s market cap might be about $3 billion
        - Resideo’s debt would be around $1.25 billion
            - So, Resideo’s enterprise value would be around $4.25 billion

- Adjusted EBITDA (after environmental expense of $140 million a year) would be around $410 million
- So, in this scenario the company would be priced at
  - 15 times free cash flow (Market cap / FCF = 15) and
  - 10 times EBITDA (Enterprise Value / EBITDA = 10)
  - Debt / EBITDA would be 3 times
- Those look like normal numbers
  - Debt / EBITDA of 3x is manageable though not especially safe
  - 15 times free cash flow (leveraged) is normal though not especially cheap
  - 10 times EBITDA (in today's market) is normal though not especially cheap
- But, there are two BIG caveats here having to do with environmental liabilities
  - As long as Resideo is paying $140 million a year and NOT deducting that $140 million expense for tax purposes, the company's tax rate will be HIGHER than other U.S. public companies and its conversion of EBITDA into after-tax FCF will be LOWER as a result
  - However, as soon as Resideo stops paying $140 million a year, it will start experiencing an automatic annual escalation in free cash flow, earnings, etc.
    - This escalation could be very meaningful
      - For example: assume Resideo starts with about $200 million in free cash flow / earnings etc. on whatever common stock it has
      - Over time: Resideo "owner earnings" can grow from $200 million to $340 million (a 70% increase) WITHOUT any associated tax increase
  - If the environmental liabilities do eventually taper off, Resideo's AFTER-TAX earnings will increase by $140 million without Resideo doing anything. This is truly free after-tax earnings growth.
  - Let's look at how much EPS growth such a tapering off might cause
    - If liabilities vanish in 5 years: > 11% annual EPS growth
    - If liabilities vanish in 10 years: > 5% annual EPS growth
    - If liabilities vanish in 15 years: > 3% annual EPS growth
    - If liabilities vanish in 20 years: > 2% annual EPS growth
    - If liabilities vanish in 25 years: > 2% annual EPS growth
    - If liabilities vanish in 30 years: > 1% annual EPS growth
    - If liabilities vanish in 35 years: > 1% annual EPS growth
    - If liabilities vanish in 40 years: > 1% annual EPS growth
    - If liabilities vanish in 45 years: > 1% annual EPS growth
    - If liabilities vanish in 50 years: > 1% annual EPS growth

            - Even if it takes 50 years for Resideo's environmental payments to Honeywell to drop to zero, Resideo's EPS will grow at a rate of 1% a year because of this (of course, this assume EPS would otherwise be static – it might grow on its own)
        - We can try plugging in our best estimate of a reasonable range of how long it'll take for the environmental payments to taper off to zero and incorporate this into our EPS growth estimate for Resideo
            - Assume it takes 20-50 years: This adds 1%-2% a year to EPS
            - Assume it takes 15-50 years: This adds 1%-3% a year to EPS
            - Assume it takes 10-50 years: This adds 1%-5% a year to EPS
            - Assume it takes 5-50 years: This adds 1%-11% a year to EPS
        - If you could make some kind of aggressive assumption, like it would take no longer than 5-15 years for these environmental expenses to disappear, then you could add 3%-11% a year to your EPS growth estimate for Resideo
- Why does this matter?
    - If the market values Resideo post spin-off as a no-growth business with about $410 million in EBITDA (not about $550 million in EBITDA), then the fact that Resideo might grow EPS by an extra 3%-11% a year simply as environmental expenses sunset could make the difference between Resideo being an attractive or unattractive investment over the next 5-15 years.
- Resideo expects to require non-employee directors to hold 5 times the value of their annual cash retainer (this would be $450,000 and up) in company stock, unvested restricted stock units, etc.
- CEO will be paid $880,000 base salary
- Should make $1.9 million a year if he receives all of his targeted incentive compensation
- Get a "founder's grant" of restricted stock units with a value of $4.3 million which will vest 3 years (50% of the grant) and 4 years (the other 50% of the grant) from the date of the spin-off
- So, the restricted stock will vest 3-4 years after the spin-off and will be equal to a little over 2 times the annual salary plus bonus the CEO should expect to make
- Resideo's products are manufactured in
    - Mexico
    - Netherlands
    - Scotland
    - United States
- Reminder: The kinds of products Honeywell Home makes are not usually imported
    - Mexico and the U.S. are normal places to manufacture locally for the U.S. market

        - Scotland and the Netherlands are normal places to manufacture locally for the U.K. and E.U. market
- Cap-ex and depreciation and amortization were roughly equal from 2015-2017
    - About 105% of D&A
- Resideo's R&D costs were
    - $110 million in 2015
    - $106 million in 2016
    - $120 million in 2017
        - If all R&D expenses are related to Honeywell Home (the "products" business) then that unit might spend up to 5% of sales on R&D each year
- "Given the uncertainties regarding the status of laws, regulations, enforcement policies, the impact of other potentially responsible parties, technology and information related to individual sites, we DO NOT believe it is possible to develop an estimate of the range of reasonably possible environmental loss in excess of our recorded liabilities
- Resideo's recorded liabilities were $453 million in December of 2016 and $537 million in December of 2017
- "We expect to fund expenditures for these matters from operating cash flow"
- "We accrue costs related to environmental matters when it is PROBABLE we have incurred a liability related to a contaminated site and the amount can be REASONABLY ESTIMATED.
- Returns on capital are high in both the distribution business and the products business
- For example: the AFTER-TAX return on ASSETS (not net assets) including GOODWILL / INTANGIBLES is probably around 7% in the ADI distribution business and 10% in the Honeywell Home products business.
    - Pre-tax returns on NET TANGIBLE ASSETS would be much higher
- Geographic breakdown
    - U.S.: 69% of sales (2015-2017)
    - Europe: 23% of sales (2015-2017)
        - So, U.S. and Europe combined are 92% of sales
        - In other words: markets outside the U.S. and Europe are currently irrelevant to an analysis of Reisdeo stock
        - Note: I believe India may be the most important market outside of the U.S. and Europe
- Estimated return on NET TANGIBLE ASSETS for Resideo
    - Greater than 50% pre-tax (possibly A LOT greater)
        - Why so high?
            - Receivables and payables offset (both are around $750 million)
            - A large portion of assets are intangibles
                - $2.6 billion in goodwill
        - Tangible investment in Resideo mostly consists of

            - $523 million in inventories
            - $265 million in property, plant, and equipment
        - Which are producing several hundred million dollars in pre-tax income
    - The exact calculation isn't important
        - This is a no-growth or slow-growth business
    - What's important is that return on net tangible assets is VERY HIGH
    - Therefore: any growth in this business will be very, very valuable
- The need to re-invest capital in Resideo to grow is low
- While growing at a rate of about 3% to 4% a year, cap-ex was about 1.05 times depreciation and amortization
    - Maintenance cap-ex can be assumed to be equal to depreciation
        - Therefore: EV/EBIT can be used as a good valuation measure with the one added complication of the NON-TAX DEDUCTIBLE environmental expenses of no more than $140 million a year, but possibly – at some point – less than $140 million a year
            - Also: EBIT may be understated by about 15% relative to cyclically normal levels (due to U.S. housing activity being well below trend and non-residential activity not being especially high either
                - For these reasons, Resideo's theoretical MAXIMUM achievable EBIT given its current competitive position may be as much as 50% greater than its reported earnings because
                    - Earnings could increase 35% over time as environmental liabilities disappear
                    - Earnings could increase 15% over time as U.S. residential and non-residential construction activity reaches a cyclical high
                        - If nothing changes competitively for Resideo, it should one day – but who knows when – make about 50% more money than it will right after the spin-off happens

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