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M&A

One way to get ahead of the curve

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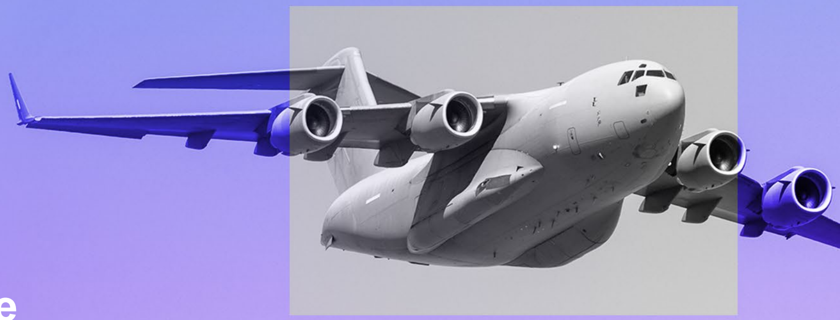

The surge in aerospace and defence (A&D) mergers and acquisition activity that we saw last year melted away in the first half of 2022 amid rising geopolitical and macroeconomic uncertainties, sharply higher interest rates, and heightened regulatory scrutiny on very large deals.

The number of transactions in the first half of the year declined to an annualized rate about 19 per cent lower than for the whole of 2021, according to a recent KPMG International A&D Mergers and Acquisitions report.[i]

Will dealmaking remain less frenetic while the cost of money stays high?

Quite possibly, but we expect many smaller technology-focused deals in the A&D industry in the coming months as original equipment manufacturers (OEMs) look to fill gaps in their strategic product and service offerings and boost their capabilities.

To date, deal activity has largely been concentrated among companies specializing in unmanned aerial vehicles (approximately 20 transactions in the past 18 months), surveillance, jamming technology, communications, and identification and cyber security.

And, with democratic governments encouraging A&D companies to nearshore parts of their supply chain ecosystem, some interesting domestic and cross-border mergers and acquisitions (M&A) opportunities are likely to emerge, particularly among Tier 2 and 3 suppliers. In larger transactions, more government oversight has been occurring, with an increased focus on protecting national security interests. This has been observed in the U.S., U.K., and Australia in particular, and may also be undertaken in Canada pursuant to the Investment Canada Act and related regulations.

In civilian aerospace, Tier 2 and 3 suppliers that are still under considerable financial stress may well seek a Tier 1 or 2 company to rescue them through an acquisition. Several OEMs have already been supporting financially stretched suppliers through the pandemic.

Think outside the box

M&A deals aren't the only way to add technological capabilities. There are also opportunities to form ties with tech start-ups. Increasingly, A&D companies are focused on partnerships, joint ventures, and alliances to spread the risk and leverage shared technology.

The product life cycle historically has been 20 years long. But, given the advancements in technology and country-specific decarbonization targets, the future is much more difficult to predict. With that in mind, A&D companies really should think outside the box for ways to reduce their exposure and hedge their bets.

For example, joint ventures are already emerging to develop batteries for urban air mobility and electric aircraft. Aeroengine makers are teaming with OEMs on the electrification of aircraft and engine systems and advanced propulsion technologies, as well as partnering with energy companies to find more sustainable aviation fuel (SAFs) solutions.

The race to develop sustainable propulsion systems is well underway.

Electrification, using either batteries or hydrogen fuel cells and hydrogen combustion using gas turbines, were identified as three potential alternative propulsion technologies with the greatest potential to reduce aviation's climate impact in the World Economic Forum's Target True Zero new report.[ii]

Given the mounting pressure to reduce the climate impact of aviation, sustainability in the defence sector and transitioning to net zero were key themes during this year's Farnborough International Airshow. Sustainability will fuel future partnerships as no single stakeholder in the A&D industry can achieve net-zero carbon emissions on their own. Other key themes from Farnborough included smart manufacturing and hyper-scaling within the industry to accelerate change.

Private equity firms are often the catalysts of these kinds of deals, the kind that will shape the future of the industry.

In the U.S., which comprises the lion's share of M&A in the A&D sector worldwide, the value of PE-related transactions totalled US$19.3 billion in the 18 months ended June 30, while special-purpose acquisition company (SPAC) deals came to a virtual standstill partly from both regulatory scrutiny and the recent stock-market rout.[iii]

SPACs, also called blank cheque deals, are shell companies set up by investors to raise money through a public offering with the goal of buying a private business.[iv] There's a limited time to complete the deal, and if the deadline isn't met, the SPAC is liquidated, and the money is returned to investors.

Last year in the U.S., SPACs were an important conduit for emerging space companies to raise capital. However, if the space subsector is going to expand more rapidly, then it may need to follow the more conventional initial public offering (IPO) route.

Change brings opportunity

The many changes, large and small, over the past few years will undoubtedly be felt in the industry for some time to come. While it's a difficult environment, it's also laden with opportunities for dealmaking provided you can be resilient, agile, and flexible.

These three traits have always characterized dealmakers and have never been more useful – or necessary - than they are now. The world economy is becoming more divided, and manufacturers will need to adapt. M&A is one way of getting ahead of the curve.

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[i] "Mergers & Acquisitions help transform Aerospace & Defence", KPMG International, June 2022

[ii] "Target True Zero: Unlocking Sustainable Battery and Hydrogen-Powered Flight," The World Economic Forum, July 19, 2022

[iii] "Mergers & Acquisitions help transform Aerospace & Defence", KPMG International, June 2022

[iv] Bailey Lipschultz, "Wave of SPAC Deals Canceled in Latest Blow to Stumbling Industry", Bloomberg News, July 1, 2022