



Entering a Pivotal Time in Defence

Deal and financing activity expected to pick up

By Grant McDonald and Peter Graham



The next five years may prove pivotal in Canada's aerospace and defence (A&D) industry.

We are likely to see more deal and financing activity not only to meet demand but also to gain additional expertise or financial flexibility in order for companies to meet their sustainability and carbon reduction targets, adopt new technologies, de-risk their supply chains and transition their aging manufacturing workforces. As current owners or founders of small- and medium-sized enterprises (SMEs) look to retire, deal opportunities will also emerge.

These trends – whether economic, decarbonization, technology, or aging demographics – will spur industry consolidation, force companies to identify growth opportunities, divest non-strategic assets, and prompt them to consider alliances, joint ventures or partnerships. Certainly, original equipment manufacturers (OEMs) continue to look to fill gaps in their strategic product and service offerings and boost their capabilities, and private equity firms are looking to grow their A&D portfolios.

In the current high interest rate environment, carving out a business for divestment can be an effective way to raise capital, reduce debt, and allow the company to focus on its core business. Carve-outs, however, can be complex and need to be extremely well executed.

Promising Fundamentals

The sector fundamentals are promising. Economist David Rosenberg recently opined that investors are expecting earnings-per-share growth anywhere from 15 per cent in the U.S. small-cap A&D space to as much as 96 per cent for U.S. mid-caps and 36 per cent for U.S. large caps.ⁱ

With wars in Ukraine and the Middle East and heightened geopolitical tensions, defence spending will remain high, although still intrinsically tied to fiscal policy manoeuvrability.

In the five-year period from 2017 to 2022, global military spending jumped 28 per cent to nearly US\$2.21 trillion.ⁱⁱ Since 2000, it's tripled from US\$741.9 billion.ⁱⁱⁱ

New contracts will be signed, equipment purchased, and military stockpiles refilled. Five Eyes defence departments

as well as those in Europe will have little choice but to continue investing in training, equipment maintenance and digitally modernizing their operations to ensure military readiness and counter cyber threats.

The U.S. is Canada's key export market, accounting for nearly half of Canada's approximately \$6.5 billion of defence exports.^{iv}

The proposed budget for the U.S. Department of Defense (DoD) in fiscal year 2024 totals US\$824 billion, about the same as the amount appropriated for 2023, and would remain nearly unchanged when adjusted for inflation through 2028, according to the Congressional Budget Office (CBO).^v The cost of DoD's plans would increase by 10 per cent, reaching US\$922 billion in 2038, the CBO projects.

Winning Deals

Successful acquisitions don't just happen. They start with a well-defined vision of success and a robust strategic rationale with a clear understanding of the risks and rewards and the buyer's ability to take control, capture value, and manage risk.^{vi}

The challenge is to scan the market and identify, qualify, and engage suitable targets for acquisition. While the defence industry is tight-knit, there are hundreds of SME players in Canada, mostly privately held. Private companies tend to keep their financial results confidential so the manner in which the target is first engaged sends a strong message that the buyer is legitimate, serious, and prepared to cut a deal.

The structuring of the deal is essential to protect the value of the business and maximize potential returns. The acquirer may need to seek relevant indemnities against key risks or areas of uncertainty, such as environmental remediation, and whether the business will be delivered debt free or with an agreed level of working capital. The funding of the deal – debt, equity, cash, or a combination thereof, including terms and

conditions, and an early assessment of the structure from a taxation perspective will determine how much flexibility management has to operate the business to achieve growth objectives and realize post-acquisition synergies.

Another critical part of any M&A activity is the due diligence process. The buyer or investor must have assurance of what they're getting. Due diligence will confirm and verify information, identify current operational shortcomings, reveal potential issues, and better understand the key drivers of business performance and market dynamics.

Equally important is to understand the target company's people and culture and to identify key talent early and put plans in place to retain them. Because people naturally dislike change and uncertainty, it's critical to have an effective communication strategy to reduce anxiety, motivate talent, and deliver value post completion.

Just because the deal is complete, it doesn't mean that it's done.

Post-completion, a much deeper dive can and should be done to identify additional value and maximize the returns.

Grant McDonald is the Global Aerospace and Defence Industry Sector Leader at KPMG International. **Peter Graham** is a Partner in Deal Advisory and the Aerospace and Defence Industry Leader for KPMG in Canada. For more information, visit, www.kpmg.ca. The views expressed here are their own and do not necessarily reflect a CDR editorial position.

Contact us

Grant McDonald

Global Sector Leader,
Aerospace & Defence
KPMG in Canada
246-434-3900
grantmcdonald@kpmg.ca

Peter Graham

National Sector Leader for
Aerospace and Defence
KPMG in Canada
416-777-8229
peterjgraham@kpmg.ca

ⁱ David Rosenberg and Marius Jongstra, "This one sector is looking like a buy in an overall shaky stock market," The Globe and Mail, October 30, 2023

ⁱⁱ Military expenditure, Stockholm International Peace Research Institute (SIPRI), The World Bank Group, 2023

ⁱⁱⁱ Ibid

^{iv} Statistics Canada's Canadian Defence, Aerospace, Marine and Cybersecurity Industries Survey (2020), 2022.

^v Long-Term Implications of the 2024 Future Years Defense Program, Congressional Budget Office, October 25, 2023.

^{vi} Buy Right, KPMG, 2015