Mergers & Acquisitions help transform Aerospace & Defense

KPMG International

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Foreword

The excitement and challenges of working in the Aerospace and Defense (A&D) industry continue unabated, not least in the field of mergers and acquisitions (M&A). Although companies became less preoccupied with COVID-19 in 2022, new events disrupted the prospects for a smooth recovery and they are likely to reverberate for the foreseeable future.

In our 2021 report on M&A in aerospace and defense, we predicted that geopolitics, the pandemic and digital transformation would change the face of A&D. The view proved prescient. The war in Ukraine, which began on February 24, 2022, showed that great power politics had re-emerged as a significant driver of security policy.

Western countries, especially in Europe, are now working more closely together in the face of military aggression. NATO has a new lease on life and defense cooperation among democracies in both the Atlantic and Pacific regions has become a higher priority. The change in the political and security environment has a significant impact on A&D, including in mergers and acquisitions. In civilian aerospace, manufacturers and airlines are adapting to a jump in pent-up travel demand, as health restrictions have eased.

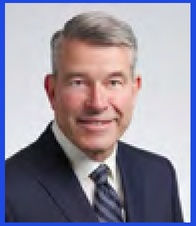
Dealmakers lead the way in developing new forms of business cooperation in light of the rapidly changing environment. The 2021 report predicted a surge in M&A deals, fueled by strong cash reserves and a desire to protect supply chains. Large scale deal activity declined in 2022 with a number of factors at play — valuations remain high, the number of available deals are relatively scarce and governments have further increased transaction oversight to protect national security interests. Higher interest rates in order to decelerate inflation is also playing a part.

Will dealmaking remain less frenetic while the cost of money stays high? Quite possibly, but we predict there may be many smaller technology-focused deals in A&D in the months to come as OEMs race to compete and fill in holes in their strategic product and service offerings. Financial investors may also continue to play a greater role in sourcing corporate combinations that offer an opportunity for higher return on investment.

In the longer term, A&D executives remain focused both on building their technological capability and strengthening their supply chains. Environmental objectives are also becoming a higher priority and will likely help shape the M&A deals of the future.

To chart a path through this rapidly changing environment, we analyze the various factors leading A&D investment in new directions. Interviews with industry executives as well as KPMG's A&D subject matter experts also provide an important perspective.

In the midst of turmoil, one thing seems clear. The world economy is becoming more divided and manufacturers will have to adapt. M&A is one way of getting ahead of the curve.



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Geopolitical disruptions

War and inflation have shifted the global aerospace and defense (A&D) industry onto a new path, and the pattern of mergers & acquisitions (M&A) is likely to follow the trend. Rising prices and tighter monetary policy around the world may dampen dealmaking somewhat in the short term. In the long term, however, the need to strengthen supply-chain sustainability and adapt to geopolitical changes is going to make it more important than ever to use M&A as a tool to accelerate industrial transformation.

Indeed, there seems to be a consensus that the most significant event for A&D in the past year was Russia's invasion of Ukraine and the measures taken in response by Western governments. Many were taken by surprise, but the Western government response has been swift. While exports of Russian steel were subject to sanctions, key strategic materials such as nickel and titanium were not. Boeing suspended titanium purchases from Russia, saying it had sufficient stockpiles and diversity of sources to supply its needs. By contrast, Airbus relies on Russia for about half of its titanium and, so far, continues to buy from there.

Boeing halted the operations of its Moscow Design Center where it employs 1,000 people. Safran of France suspended its joint venture with Sukhoi in Russia which produces engines for a regional jet. Honeywell and RTX-Collins suspended all sales, distribution and service activities in Russia.

"Russia must be worried that the degree of self-sanctioning among companies is much more extensive than in the past," says David Gordon, Global Macro Strategist at the Eurasia Group, a think-tank. "Many companies have not just suspended operations, but are actually pulling out. Depending on the outcome of the war in Ukraine and in the absence of a diplomatic solution, we're heading toward a big disconnect between Russia and the West."

The war in Ukraine was the latest in a series of shocks to the supply chain of A&D manufacturers, revealing supply chain vulnerabilities and disruptions between OEMs and their suppliers. "Airframers and Tier-1 suppliers are intensively considering whether they need to acquire content or technology at strategic parts of the chain to reduce risk. Alternatively, they are entering into long-term purchase agreements to lock in supplies," says Jim Adams, National A&D Leader, KPMG in the US "US makers of defense equipment are examining their supply chains and if they see geopolitical risks growing, they are considering moving parts of the chain back home."

Governments are encouraging the transition. The US Defense Department released a report on strengthening defense-critical supply chains on February 24, 2022, the day Russia attacked Ukraine. "We will prioritize cooperation with our defense industrial base and with all others who have a stake in our national and economic security to collaboratively safeguard global market integrity and strengthen defense-critical supply chains," says Deputy Secretary of Defense Kathleen Hicks. Other countries that are pursuing similar policies include the UK, France, Japan, and Australia.

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> **Jim Adams,**
> National A&D Leader
> KPMG in the US

Flexible approaches to dealmaking

These moves by governments to encourage companies to shorten supply chains are being answered by A&D companies as they strive to nearshore parts of their ecosystems. "A&D companies have begun to rely less on global supply chains and to focus more on centering production regionally. This could create interesting M&A opportunities," says Yael Selfin, Chief Economist, KPMG in the UK.

Those opportunities are more likely to be seen among Tier 2 and 3 suppliers than at the level of OEMs. The larger the deal, the more political it becomes. Stéphane Souchet, Global Head of Industrial Manufacturing, KPMG International, remembers that a proposed merger of Airbus and BAE Systems in 2012 was dropped in the face of government opposition. "The conditions for large-scale transactions to occur are more favorable than in the past few years, but the obstacles to megadeals remain pretty high and it would still also depend on political agendas at the time," he says.

There are a lot of opportunities for A&D companies to acquire or form ties with emerging firms. But A&D companies lack the experience of tech firms in taking strategic stakes in promising, young enterprises. The former therefore tend to take a more cautious approach to becoming directly involved in the equity of emerging companies. Yet there is a strong imperative to be flexible about how to participate in new technologies.

Michelle Le Merre, Finance Director, Corporate Development & Strategy, at BAE Systems, says her company's acquisition strategy is "to pursue innovative complementary technologies of varying sizes. BAE is creative around structuring and can fully acquire businesses, participate in joint ventures or take smaller equity stakes. We acknowledge the unique corporate culture of each acquisition, such as our recent acquisitions of In-Space Missions (satellites) and Bohemia Interactive Simulations (military training simulations). We don't want to destroy the value that we've just acquired. We are working early on in the process to build integration plans into our acquisition strategy to ensure we achieve the best outcome and also give the management team the bandwidth to execute on their business plan."

Glynn Bellamy, UK M&A lead for Aerospace & defense, KPMG in the UK, says A&D companies are increasingly focusing on partnering, joint ventures and alliances, not just outright mergers, to spread the risk and leverage shared technology. "The product life-cycle has historically been 20 years long, but the future is more difficult to predict than ever, so individual companies are reducing their exposure and hedging their bets," he says. An example is the electrification of the airframe, where the scale of investments in new technologies is likely to be extremely large. Another example is aeroengine makers partnering with oil companies to find more sustainable fuel solutions.

In 2021, Safran and Boeing announced a joint venture to develop batteries for urban air mobility and electric aircraft projects. GE Aviation and NASA have partnered to develop inverters for large commercial electric aircraft.

"We're seeing more tech companies out there that have really promising technological capabilities, especially among start-ups."

Mike Oakley
Senior Director,
Corporate Strategy and Development,
L3Harris Technologies

The war in Ukraine has supported the longstanding view of those in the defense industry that say manufacturers contribute to social sustainability by helping to ensure international stability. Despite short-term tactical responses to the conflict, in the long term, the sustainability of operations, in general, and of supply chains, in particular, will remain a major focus for investors, customers and employees. ESG factors are therefore expected to be a significant consideration for dealmakers. "Environmental pressure on A&D is likely to increase, prompting companies to invest in a range of technologies to see which will be the most successful," says Bellamy.

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Glynn Bellamy
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KPMG in the UK

Strengthening industrial sovereignty in a global business

Tikehau ACE Capital, based in Paris, Toulouse and Madrid, is a unique PE company that is specifically focused on the A&D sector and takes a longer-term position in the companies it invests in. Its deep knowledge of the industry is buttressed by an advisory group of executives who are, or were, employed by some of the biggest names in European industrial manufacturing, such as Airbus, Safran, Dassault, Framatome, Alcatel, Daher, Schlumberger, Valeo and Stellantis.

The deal in February by Tikehau Ace Capital, Safran and Airbus to acquire Aubert & Duval, a strategic supplier of critical parts for A&D, exemplifies the company's approach (see "Private equity gains and SPAC deals recede"). "The acquisition of Aubert & Duval is a great example of the requirement for flexibility if you want to be a PE player in a long-cycle sector. The company has some unique assets, very scarce know-how and an unrivaled client base," says Guillaume Benhamou, Managing Director and CEO of Tikehau Ace Capital. But this is not a typical PE story. "It's too complex; it's going to take too long and is too risky for an ordinary PE firm. As an investor, we wouldn't have done it without the participation of Safran and Airbus."

The press release announcing the deal said the intention is to reinforce French and European Union industrial sovereignty by offering an autonomous supply of critical materials. But businesses such as Aubert & Duval will not be protected behind European walls, says Benhamou. "If Europe wants to have a powerful and effective industrial base, then these types of businesses need to have a European capability, presence and know-how. But this doesn't prevent them from being global players. It doesn't mean you can't source from other places such as the US," he says.

Government policies encourage stronger supply chains

In response to rising global tension and increasing supply chain disruptions, democratic governments are looking for ways to strengthen national capabilities in defense manufacture.

In Europe in particular, the sense of a common security threat from Russia may encourage more international industrial cooperation. "There is a greater sense of collaboration among nations than before and this may lead to significant cross-border deals in the future," says Grant McDonald, Global Head of Aerospace and Defense, KPMG International. Eurasia Group's Gordon agrees: "The growing perception of a strategic threat from China and Russia's invasion of Ukraine has created a context for thinking about alliance cooperation."

Defense policy makers are likely to take a somewhat flexible approach toward M&A. "European governments want to strengthen their indigenous industry, although they would be more likely to countenance foreign investment if indigenous industry was protected through undertakings or investment that led to enhanced sovereign capability," says Bellamy. "The policy may end up leading to industry consolidation within a country in order to increase supply chain resilience," he says.

At a time when fiscal budgets are stretched, governments will be more concerned than ever about keeping defense-procurement costs under control — in the face of rising inflation. As a result, officials are watching closely for M&A deals that could dampen competition. An example of this is Lockheed Martin's attempt, abandoned in February 2022, to acquire Aerojet Rocketdyne for US$4.4 billion. In a statement, the US Federal Trade Commission (FTC) said: "The acquisition would have eliminated the country's last independent supplier of key missile propulsion inputs and given Lockheed the ability to cut off its competitors' access to these critical components." It noted that the FTC's enforcement action coincided with a Pentagon recommendation for "stronger merger oversight of the highly concentrated defense industrial base."

Since January 2022, the UK's National Security and Investment Act allowed the British government to review post-closing transactions deemed to be a possible risk to the UK's national security. British A&D deals that have come under government scrutiny include the proposed acquisition by Parker-Hannifin of the US of Meggitt for US$9 billion and the US$3.6 billion bid from Cobham (owned by US private equity firm Advent) for defense supplier Ultra Electronics.

The Indian government, mindful of growing risks in the region, is pushing hard for the indigenization of defense production, to reduce reliance on imports and build up India as a global manufacturing hub. A growing number of foreign companies, mainly from the US, France and Israel, have either announced or are contemplating the establishment of maintenance, repair and overhaul (MRO) facilities in India. Boeing has expanded its existing MRO capabilities in the country to include the C-17 strategic transport and P-81 Neptune anti-submarine aircraft. By contrast, Safran has decided to set up an MRO facility in Hyderabad. These ventures are seen as a step toward co-development and co-production.

"The theme is very clear, but how is India to reach an indigenous content requirement of at least 50 percent, with limited domestic availability of raw materials and significant technology needs? This is the biggest pain point," says Gaurav Mehndiratta, Industry Leader — A&D, KPMG in India. To achieve this, India can expect to see foreign defense manufacturers collaborating with large Indian companies, as well as setting up their own subsidiaries, he says.

A key indicator of the government's policies will be the decision, due by the end of 2022, concerning its US$20 billion Multi Role Fighter Aircraft project. The project may be placed under the policy of 'Buy Global — Manufacture in India'. Leading candidates to win the business include companies from the US, Europe and Russia.

Civilian aerospace at a turning point

Outside of the defense sector, the airline industry and the manufacturers that supply the planes face a patchy recovery that is unlikely to relieve pressure on makers of components. "In the short-term, we expect leisure travel to rise strongly, but it will take a long time for air travel to return to pre-COVID levels. To meet their net-zero targets and cut costs, companies may continue to limit business travel and rely more on videoconferencing. This will limit the rate of recovery," says Selfin.

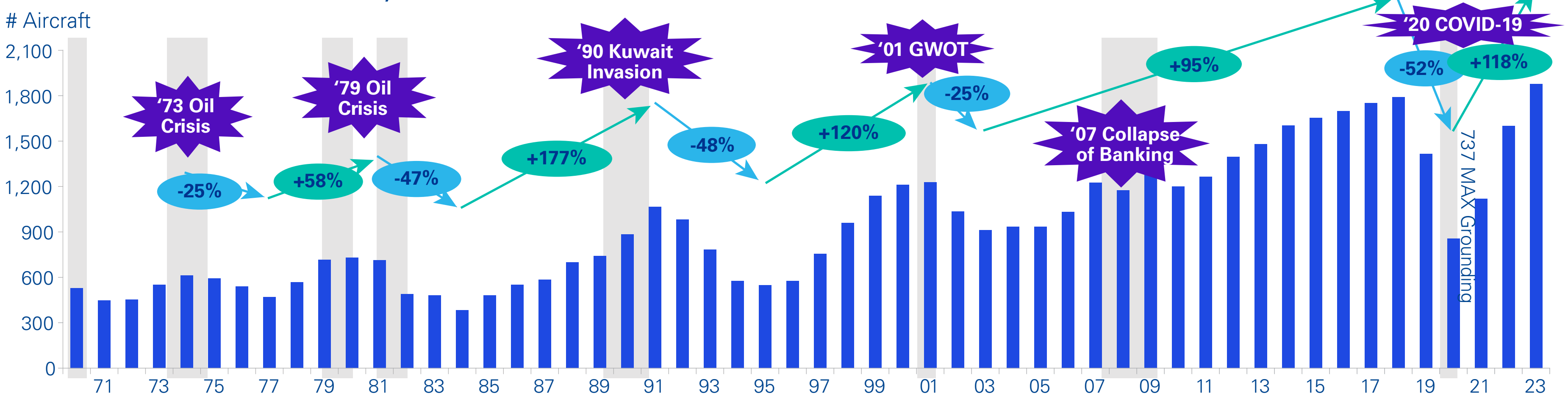
Aviation executives had hoped for a strong rise in airplane orders after a steep downturn in 2018-20, but Boeing and Airbus deliveries in 2022 are still likely to be below their level in 2019. Tier 2 and Tier 3 suppliers that are under considerable financial stress may seek a Tier 1 or Tier 2 company to rescue them through acquisition.

"I'm not sure, though, that this level of stress means there will be more M&A," says Adams. "Many forces are at work: production rates are not as high as before and input costs are going up. Production rates are recovering for narrow-bodied aircraft, but not for wide-bodied planes such as the Boeing 787."

As for airlines, M&A in the US is likely to focus on Tier 2 companies, such as JetBlue, Frontier and Spirit, already highly consolidated.

A volatile production cycle

Global Commercial Aircraft Deliveries, 19702023



Notes: Boeing, Airbus and other (includes Embraer, Bombardier, ATR, and limited Russian aircraft; excludes China); FY20 Boeing Deliveries are for Q1 only.
Sources: Individual Company reports, press releases, CapIQ and Dacis

Trends in M&A deals

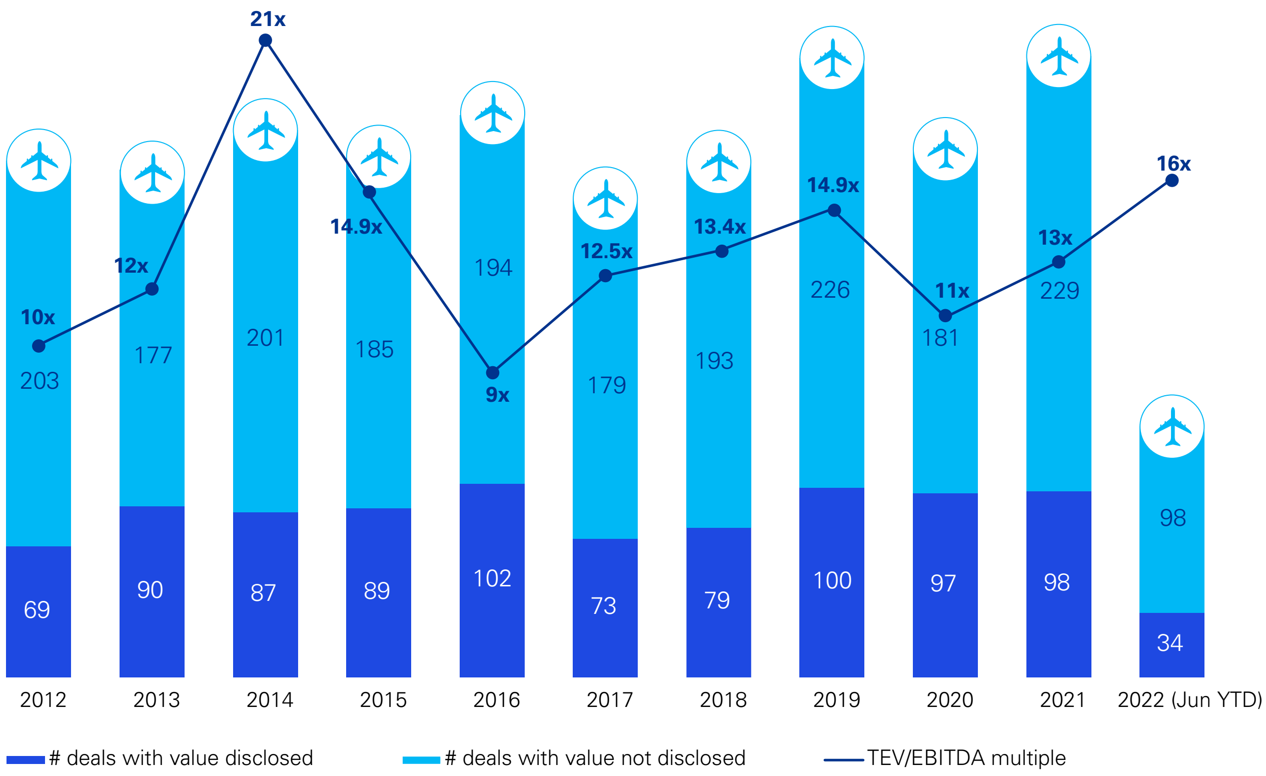
As predicted in the 2021 KPMG report, Future of M&A in A&D, there was a surge in M&A activity last year. The number of deals worldwide rose by 18 percent to 327 in 2021. Valuations also grew from a TEV/EBITDA of 11 to 13. In the first half of 2022, the number of deals declined to an annualized rate about 19 percent lower than for the whole of 2021. But valuations rose from 13 in 2021 to 16 in the first half of 2022.

The picture was similar in the US, which comprises the lion's share of M&A in the sector worldwide, where volume rose sharply in 2021, exceeding the totals in 2019 and 2020 by more than 20 percent. However, the total deal value of US$63 billion, while double 2020's amount, was US$46 billion less than in 2019.

Between January and June 2022, A&D deal value in the US fell to US$8 billion from US$33.6 billion in the latter half of 2021 and almost US$60 billion for last year as a whole. Deal volume in the first half of 2022 totaled 128 compared with 189 in July to December 2021 and 358 for the whole of last year. This downward trend reflected similar changes in other areas of IM, as dealmaking shrank in the face of economic and political uncertainty.

"Deal activity worldwide is slowing and clients have become more discerning, in response to a rapid rise in geopolitical and macroeconomic uncertainties," says Souchet. He says hot spots include companies specializing in unmanned aerial vehicles (approximately 20 transactions in the past 18 months), as well as surveillance, jamming

Total deals in A&D Globally



Sources: Individual Company reports, press releases, CapIQ and Dacis technology, communications, identification and cyber security — mostly driven by a desire to enhance technological capabilities.

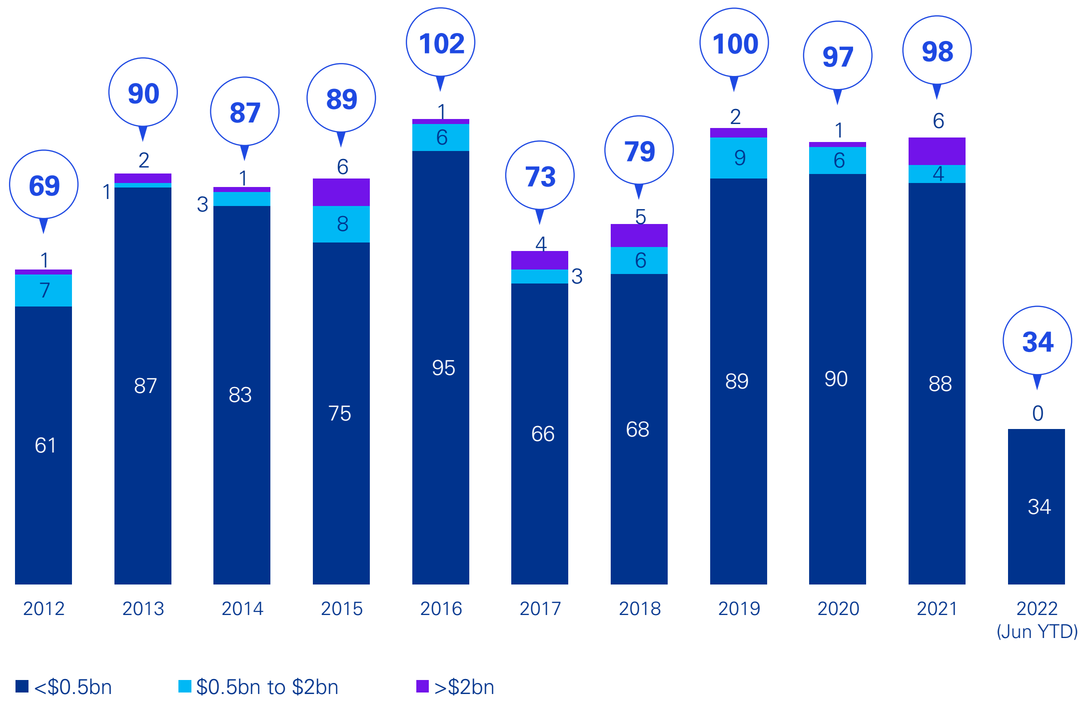
Cross-border M&A deals involving the US saw a mixed picture. Transactions into the US totaled US$1.2 billion in the first half of 2022, compared with US$3.8 billion in the previous 12 months. Outbound transactions from the US totaled US$1.3 billion in the first half of 2022, against US$20.7 billion the previous year.

Civilian aerospace M&A activity began to warm up in the second half of 2021, as financially strong aerospace companies acquired smaller companies with balance sheets stretched by the impact of COVID; but the trend abated in 2022, due to political and macroeconomic uncertainty.

> "Deal activity worldwide is slowing and clients have become more discerning in response to a rapid rise in the geopolitical and macroeconomic uncertainties"

Stéphane Souchet
Global Head of Industrial Manufacturing,
KPMG International

Deal volume by average value of disclosed deals



Sources: Individual Company reports, press releases, CapIQ and Dacis

Private equity gains and SPAC deals recede

PE firms are taking a bigger role in M&A deals for A&D companies. This can be seen in the US, where the value of these transactions totaled US$19.3 billion in the 18 months to the end of June 2022. This compared with US$32.4 billion strategic deals in the same period. "PE dealmakers are looking at how to deploy capital more innovatively, for example by placing longer-term bets than before," says Glynn Bellamy, M&A lead for Aerospace & defense, KPMG in the UK.

In contrast to the heightened activity in private equity, SPAC deals have come to a virtual standstill in the US, as the investment category is more intensely scrutinized by regulators such as the SEC. In early 2021, SPAC deals were an important conduit for emerging space companies to raise capital.

These changes are expected to have a disproportionate impact on areas of A&D where technological change is occurring rapidly and new entrants are making their mark. In 2021, 12 space startups raised nearly US$4 billion through SPAC deals. In early March, Tomorrow.io canceled a proposed SPAC deal. But satellite equipment maker SatixFy said in March 2022 that it planned to go public through a SPAC.

If the space subsector is going to expand rapidly, then it may have to follow a more conventional IPO route, which was the route followed by Canadian space technology firm MDA Ltd. in 2021. At the same time, those companies that did take merge with SPACs will be working hard to restructure their businesses to enable them to grow sustainably.

Lessons for the future

The dramatic changes in geopolitics and the macroeconomy of the past year will shape the A&D sector in ways large and small for a long time. In such a difficult, yet opportunity-filled, environment, three qualities of dealmaking are likely to yield significant benefits:

Resilience. The concept of supply chain sustainability has broadened for A&D companies. Environmental, social and governance criteria remain very important for stakeholders, but the war in Ukraine has underlined the need for a more resilient kind of sustainability, one that is designed to adapt rapidly to geopolitical events.

Agility. There are a finite number of profitable M&A opportunities at any given moment and corporate targets that enhance business value are going to command a premium, whatever the market conditions. Speed and confidence are prerequisites, but they must be based on a strong business intelligence and superior decision-making ability.

Flexibility. Mergers and acquisitions are not the only way to add technological capabilities. Aerospace and defense companies are more willing than ever to consider joint ventures, partnerships and other forms of alliance with companies large and small. PE firms are often catalysts of these kinds of deal.

These traits are likely to be more useful for A&D dealmakers in the future than ever before. Global power competition is magnifying security risks and, as a consequence, corporate competition will also remain hot, as companies search for the best M&A deal.

> “We predict there will be many smaller technology-focused deals in A&D in the months to come as OEMs race to compete and fill in holes in their strategic product and service offerings.”

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