Aerospace & Defense M&A 2023

Amid continuing uncertainty, investors look for assets to support growth and improve efficiency

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Introduction

Across the global economy, industries have been roiled by the events of the past three years—the pandemic, broken supply chains, inflation, Russia's war against Ukraine. Perhaps no industry has felt the effects more profoundly than aerospace and defense (A&D). With their planes grounded in 2020, airlines cancelled orders for new aircraft and cut back orders for spares. M&A activity in the sector plunged by almost 20 percent from 2019 to 2020 (Exhibit 1).

Following a brief rebound in 2021 and early 2022, M&A activity declined in the second half of 2022, as rising interest rates and economic uncertainty depressed equity markets. These factors continue to impact the M&A outlook in 2023. Although air travel bounced back in 2022 (albeit not fully in long-haul and business), the commercial aircraft sector has shifted from demand-constrained to supply-constrained. The Russia-Ukraine war and rising global tensions have contributed to high energy prices, high inflation, capacity constraints, and retrenchment policies. These factors, plus a super-tight labor market, have contributed to supply bottlenecks.

Rising geopolitical challenges drove a record Department of Defense appropriation in fiscal 2023, benefiting the defense industry. The final bill exceeded $800 billion, an increase of nearly $70 billion over FY22. But defense companies also faced supply constraints.

In 2023, expectations for a severe recession as a result of Federal Reserve rate hikes have faded, but the high cost of capital and inflation risk remains a strong headwind for the sector and continues to limit M&A activity. In this paper we look at the trends that are shaping the A&D business today and how they will shape M&A activity in 2023.

Trends across the A&D sector

Commercial aerospace

The pandemic forced A&D companies to cut back production and capacity. Getting back to pre-pandemic levels remains a challenge. Supply-chain constraints (including the impact of the Russia-Ukraine war, on metals such as titanium) remain an issue. Labor shortages have impacted both airlines and aircraft manufacturers. The strong dollar and inability to pass on high inflation costs are impacting profits across the supply base. Despite the resumption of air travel and renewed demand for single-aisle aircraft, high borrowing costs have depressed margins and reduced cash flows across the entire commercial aerospace ecosystem. Facing margin pressures, OEMs are pressing suppliers to improve efficiency and increase innovation, while rapidly increasing output. Second- and third-tier parts suppliers are particularly hard pressed to respond. Many have weak balance sheets and low cash reserves because of the pandemic and are constrained by the high cost of capital. They also operate under fixed-price contracts that limit their ability to pass through input price increases.

Defense

Although uninterrupted government funding shielded defense contractors during the pandemic, certain subsegments experienced production delays due to supply chain issues. Post-pandemic, defense suppliers continue to wrestle with supply constraints and labor shortages.

Last December, President Biden signed the 2023 National Defense Authorization Act, with a final DOD budget of $816.7 billion (a 13 percent increase over FY22), which included $45 billion increase to offset inflation.[1] Even so, defense industry leaders remain highly concerned about rising costs. On the positive side, the Russia-Ukraine war continues to drive defense spending in the U.S. and in Europe. NATO members have committed to increasing defense budgets up to or exceeding the 2 percent of GDP target for alliance nations.

[1] Source: Senate Appropriations Committee

Economy and geopolitics

Leaders of A&D companies—like their counterparts across industry sectors—remain bearish on the outlook for the U.S. economy in 2023. The outlook is mixed at best: the effort to control inflation via Federal Reserve interest rate hikes has taken a toll on financial markets and deal activity, but unemployment and consumption have remained strong. Demand for air travel is back, but supply-chain constraints and hesitance to invest by second- and third-tier suppliers could hamper production of new aircraft.

Global tensions are impacting A&D directly. Escalating U.S.-China trade and national security clashes have influenced jetliner purchases and certification by China. U.S. policies, such as the CHIPS and Science Act and limits on tech exports, are accelerating a decoupling of the two largest economies. The Russia-Ukraine war and other global concerns (Taiwan, North Korea, Iran, etc.) may limit foreign sales for the commercial segment while benefiting defense.

ESG pressures

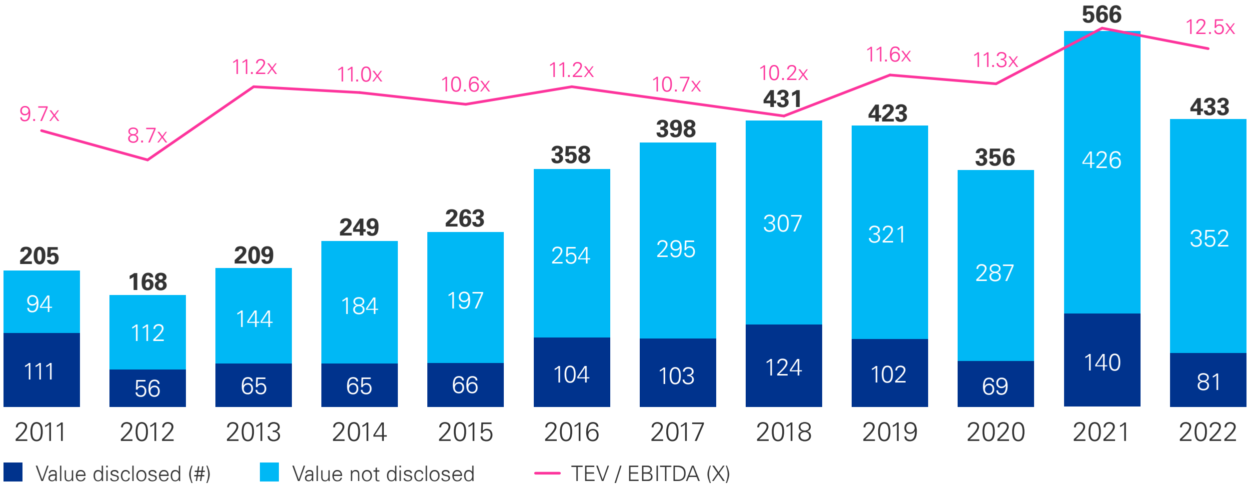
Stakeholder demands for transparency on environmental, social, and governance (ESG) performance are growing across industries. These pressures create unique challenges in aerospace as well as growth opportunities. Renewed airline commitments to achieving net-zero emissions by 2050 under the latest Paris Agreement and rising fuel prices have revived focus on the Sustainable Aviation Fuels (SAF) initiative.[2] However, the effort is held back by high costs, significant private and public sector investment requirements in infrastructure, and lack of global standards for adoption mandates and composition of SAF feedstock.

[2] Source: IATA.org

The 2023 M&A landscape for A&D

In 2022, M&A activity across industry sectors plunged after hitting recent highs in 2021. A&D was no exception: after hitting 566 transactions in 2021, deal volume dropped by more than 23 percent. Estimated deal value plunged by more than 60 percent (Exhibit 1).

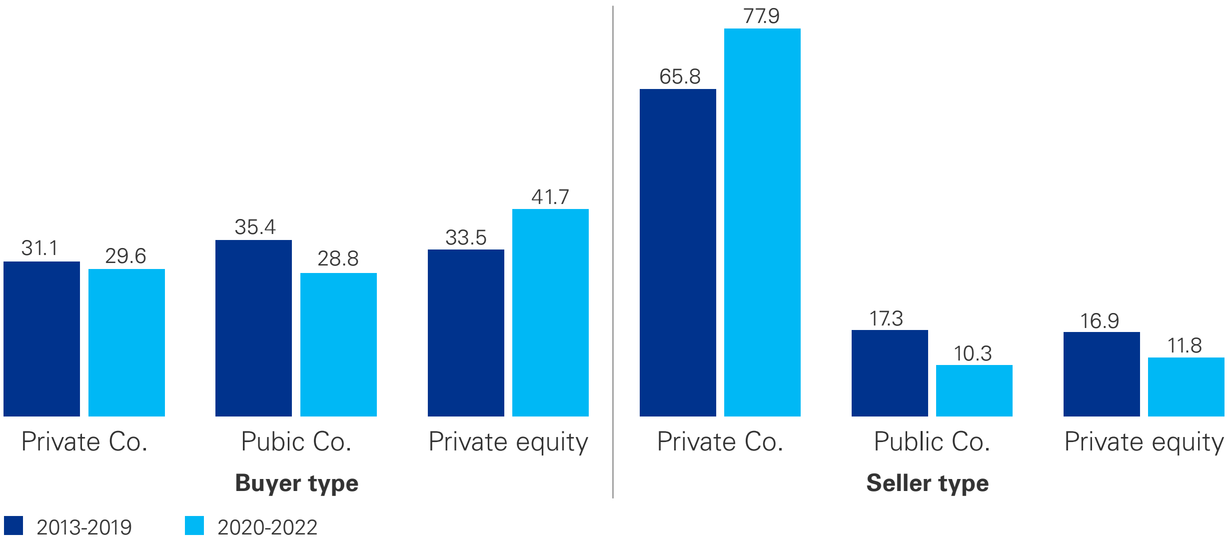
Exhibit 1: A bumpy ride for A&D deals



Source: Capital IQ, Dacis, company reports

Since the pandemic, private equity has dominated buy-side deal activity in A&D (Exhibit 2). This is driving consolidation in government IT services, cyber and intelligence, electronics, space systems, machined and cast parts, and MRO and logistics. Some small and mid-cap public companies such as Cubic, Signature Aviation, have been taken private by PE investors.

Exhibit 2: More PE activity since the pandemic

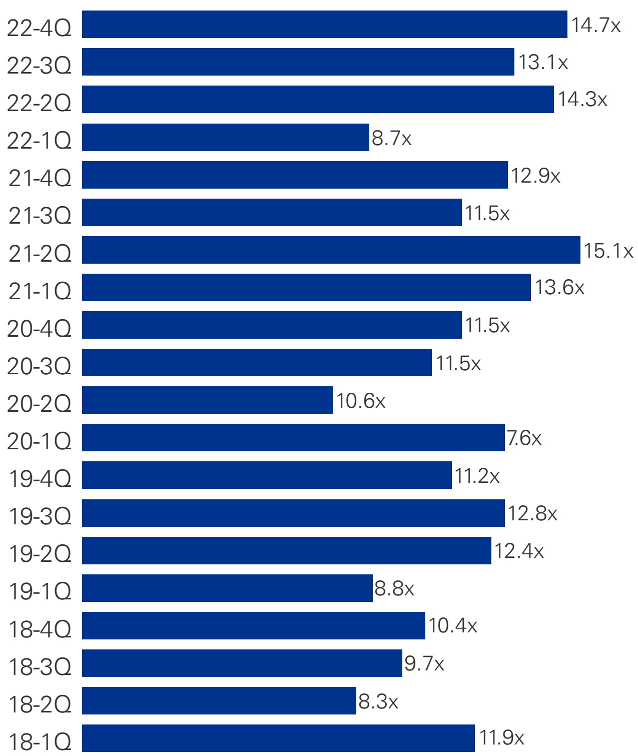


Source: Capital IQ, Dacis, company reports

Despite recent market volatility, valuations have remained persistently high, we believe values could moderate in 2023, as buyers become more selective and face challenges to achieve ROI objectives.

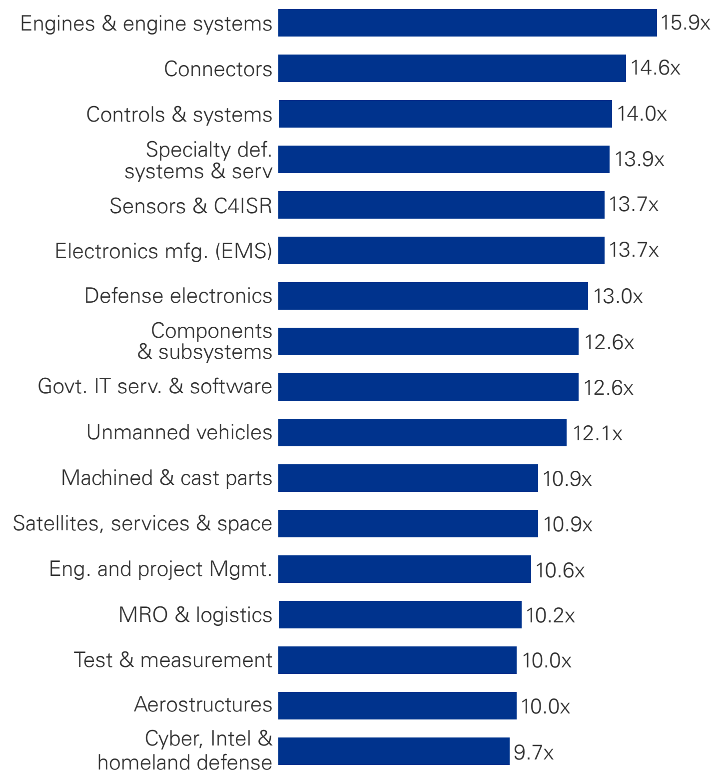
However, we also expect assets in high-tech and high-growth sub-segments will continue to command attractive valuations.

Exhibit 3: Valuations have held up



Reported with TEV / EBITDA Multipes

Exhibit 4: Where valuations are highest



Reported with TEV / EBITDA Multipes

Note: no deal values were disclosed for the Navy/Maritime, Prime contractors, Simulation & Training, Engineering & Project management, Aircraft interiors and Land system subsegments for 13 quarters ended 3Q'22.

2023 deal outlook

So far, there is little indication of a strong recovery in M&A in 2023. In addition to macro-economic headwinds—high interest rates, slowing GDP growth, continuing inflation, and labor shortages—A&D deal making faces continuing challenges of its own.

Financial pressures

Many players continue to struggle with liquidity constraints, high financing costs, and labor shortages. Economic uncertainty is limiting expansion investments by lower-tier suppliers to meet rising build rates by commercial OEMs. For defense contractors, there are concerns over possible cuts to discretionary defense spending in upcoming budget battles and continuing focus on affordability by DOD.

M&A perspectives

- Private equity will continue to focus on middle-market growth-oriented acquisitions with increased frequency of platform building on relevant technologies, notably in the areas of cyber and cryptography. Expect more creative financing solutions due to current lending environment.
- OEMs and tier 1 suppliers are expected to continue to focus on niche tuck-in deals--complementary technologies and vertical integration of strategically important vendors.
- Antitrust concerns could likely restrain large corporate-wide mergers.
- Pull back in VC and SPAC markets along with recent de-SPAC failures to drive selective opportunities.
- Pursuit of cost competitiveness to drive midcap public companies to explore going private.

M&A hotspots

- Supply chain solutions: We expect that A&D companies will continue to invest in supply-chain capabilities to help manage rising costs and other supply chain challenges.
- Consolidation of second- and third-tier players, particularly in highly fragmented segments such as casting and forgings, machining, fabrication and processing, MRO and aftermarket, and government services, especially given less pressure from the DOD limiting consolidation opportunities.
- Investments in growth.
  - Investments in high-tech sector as decoupling from Asia gains momentum.
  - Access to innovative technologies (SAF, electrification, hydrogen cells, etc.).
  - Space investments aligned to DOD mission priorities: spacecraft, launch systems, proprietary systems, and technologies, and C5ISR capabilities.
  - Low-tech armaments and missile defense system subsegments as DOD funding is directed to replenish depleted stockpiles due to Russia-Ukraine war aid.
  - Aftermarket and Business and General Aviation (B&GA) suppliers may seek growth away from OEM platforms (Boeing).

A guide to dealmaking in 2023

Where to look for deals in 2023 The A&D sector faces some significant uncertainty as it proceeds into unchartered territory impacted by some considerable industry and market developments. Our perspective—corporate development teams need to monitor trigger (or inflection) points that vary across the primary A&D sectors. These inflection points can have different implications for M&A, and while specific answers are challenging in this environment, we've attempted to predict some of the key potential developments to monitor by A&D executives and related M&A implications.

Trigger / Inflection Points to Monitor	Implications for M&A
Sustained elevated fuel prices	Accelerated adoption of new technologies accelerating cross-sector deals
Elevated leisure air travel subsiding and business air travel plateaus to below pre-pandemic levels	Constrained airline revenue growth and profitability challenges ripples upstream—accelerating cost conservation driven consolidation within and across tiers, sub-segments, privatization of mid-cap public companies and shift towards non-commercial A&D platforms, with moderating valuations
Continued supply chain challenges constraining build rates	Vertical integration, lower tier, and cross-segment consolidation
Economic headwinds restrict pace of fleet expansion/ refresh, impacting the entire commercial aero echo system suppliers, MRO/aftermarket providers, etc.	Few 'big' transactions are expected; M&A focus to continue to shift towards other non-commercial aero higher growth segments
Adoption of SAF (investments, regulations, prices, and production volumes)	Cross sector investments in alternative fuel sector
Elevated financing/leasing rates	Depressed ROI metrics shift capital deployment away from M&A
Increased regulatory scrutiny delaying new variant certification	Shift in M&A focus away from assets with outsized exposure to impacted programs
Declining airline profitability	Consolidation in Airline, discretionary aftermarket, and lower tier segments
Emergence of new competition (e.g., C919, limiting foreign orders)	Cross border JVs and alliances across MRO, aftermarket, and component suppliers
Shift in duopoly balance and aircraft type	Shift in M&A preference towards suppliers with higher exposure to Airbus and single-aisle platforms
Greater adoption of AI and advanced analytics. Potential to transform/disrupt MRO and aftermarket business models, for example.	Focus on revenue enhancing/cost optimization cross-sector M&A in high-tech sector

Defense

Trigger / Infliction Points to Monitor	Implications for M&A
Favorable domestic and foreign defense budget despite worsening macroeconomic factors	M&A mix to continue to shift in favor of suppliers with higher exposure to defense
Continued Ukraine conflict	Shift in near-term M&A aligned to boosting production of war-time equipment e.g., rocket launchers, tanks, ammunition, etc.
Continued / worsening geopolitical tensions —pursuit of military superiority	Continued M&A focus on high-tech and next gen capabilities e.g., AI, Quantum Sciences, space, and counter-space, cyber, influence operations, directed energy, hypersonic, undersea capabilities, electronic warfare, etc.
Relatively few big new contracts on the horizon, outside of NGAD, FVL, and potentially hypersonic programs, potentially limiting growth opportunities	In addition to execution of launch/ramp-up on new programs, focus primarily on execution of existing programs of record – driving growth M&A aligned to new programs and cost conservation driven consolidation
Build rate announcements for established programs	Improved revenue stream transparency to drive M&A volume
Inflation adjustment announcements	Profitability and cash flow preservation to support sustained levels of elevated valuations

Space

Increase launch rates	Increased launch activity to drive high M&A valuations amongst launch vehicle and propulsion system providers
Improved $/lb to orbit metrics	Pursuit of improvements in launch economics through adoption of innovative new technologies and cost optimizing scale economies to drive M&A volume growth in the launch sector
Increased spectrum and constellation announcements despite economic and financing headwinds	Enhanced spectrum availability to drive M&A volume growth in satellite manufacturing and services, and ground equipment sectors
Continued increases in DOD funding / shifts in priorities towards space	Improved revenue stream transparency to drive continued growth in M&A volume in defense space

Government services

Trigger / Infliction Points to Monitor	Implications for M&A
Heightened geopolitical tensions and national security threats are driving DOD funding and shifts in priorities towards IT modernization, cyber, intel and high-tech capabilities	Continued M&A activity driven by PE portfolio companies and pure-play contractors seeking access to high growth markets and high-tech capabilities
Following significant upgrades driven by the pandemic and economic slowdown, IT services firms in A&D may experience a slowdown in line with overall tech weakness	Portfolio reshaping by diversified providers, divesting plateaued/declining businesses
Procurement reforms driving focus on affordability—reduction in published hourly labor rates.	Continued consolidation in the highly fragmented sector driven by PE roll-ups, pure-play contractors and privatization of mid-caps seeking cost reduction scale economies
Continued/accelerated government investment in transition to cloud	Further penetration into the sector by tech companies seeking new growth avenues. Strong balance sheets enable accelerated M&A and potentially larger deals (a large tech player might buy or merge with a significant government services player)

Broader economic considerations

Continued increases in Fed interest rates (albeit at slower pace) through to mid-2023/ inflation to approach crossover point	M&A balance shifts back towards Buyers vs. favoring Sellers. Expect valuation moderation
Persistently strong USD exchange rate	Improved purchasing power driving U.S. investor led M&A in foreign markets
Rising interest rates and equity market rebound may moderate new PE fund announcements	Shift in M&A volume mix in favor of corporate investors reversing recent trend of PE led M&A activity since the pandemic

Recent trends and regulatory considerations

Disappointing performance of newly de-SPACed companies, macroeconomic uncertainty, and tightening SEC scrutiny	SPAC deal volume expected to remain below 2020 peak levels; some underperforming de-SPACed companies likely to be taken private
Recent legislations[1] in the U.S. and continued shift towards "Buy America" initiative	Re-domiciling of critical technologies and lower tier consolidation, e.g., semiconductors, rerouting of rare earth supply chains, resourcing of aerospace grade titanium, etc.

[1] U.S. Innovation and Competition Act and the Inflation Reduction Act

Next steps

With few exceptions, the different visions of the future will require adaptation and the development of new capabilities:

Develop greater agility and be ready for opportunities that open up during 2023

- Have internal resources and advisors on standby to rapidly ramp up and ramp down M&A pursuits
- Manage cycle times to accommodate strategic pivots

Maintain focus on balance sheet and earnings:

- Manage capital spending with commercial investment practices
- Focused R&D spending
- Use technology, data, and automation to drive down costs (using internal and external data sources)

Implement an early warning system (EWS)

Monitor trigger points and provide advance notice of changes that merit action

Incorporate continuous learning into EWS to improve detection and lead time with repeated reps

In this uncertain time, robust scenario planning will help broaden the range of strategic options being considered. Scenario planning helps identify milestones and faint signals that can alter the business environment and should be monitored. Use scenario planning to:

- Broaden the field of vision to better evaluate strategic alternatives
- Gain clarity for how acquisitions can improve long-term positioning
- Stress-test options under future scenarios
- Gain buy-in and organizational alignment
- Increase execution agility by being able to recognize relevant trends as they occur

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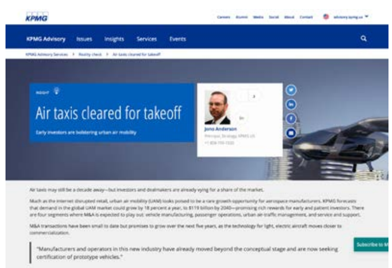

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