KPMG

After the shock

What's ahead for aerospace & defense

April 2, 2020

In this bulletin we will answer the following questions:

1. How does this compare to other shocks, such as 9/11 or the 2008 global financial crisis?
2. What lessons from previous shocks apply now?
3. How should companies be preparing for the new reality?

By addressing these questions we hope to provide insight to Aerospace & Defense companies on how they may respond to both immediate and longer-term challenges—severe contraction of economic activity associated with the COVID-19 pandemic—and potential recession that may result. In addition to immediate safety actions you have underway, we offer additional actions to consider in this challenging environment (e.g., cash preservation, supply base stability, as well as strategies to position for a recession and emerge stronger in the recovery). Industries often evolve and reshape during recessions, so we also share ideas for how to capture opportunities in that new reality.

How does this compare with prior shocks?

The COVID-19 shock differs from prior shocks to the A&D industry for many reasons. First, early indications point to a far more serious impact than either 9/11 or the 2008 financial crisis. Air traffic is down significantly, with carriers announcing unprecedented capacity reductions (deeper than those following the 9/11 attacks). One major U.S. carrier already announced that it will defer new aircraft deliveries and substantially reduce investments. Other carriers are likely to follow suit eventually leading to reductions in commercial order backlogs. Exacerbating the backlog challenge this time are low fuel prices as well as relatively young fleets; the need to modernize fleets with more efficient aircraft after 9/11 helped create a surge in demand that we are unlikely to see this time.

Finally, should businesses successfully adopt the temporary work-from-home and limited travel policies, we may see a structural shift (although small) in near-term post-epidemic (and potentially longer-term) passenger demand, also leading to a longer recovery path relative to prior shocks.

Another difference between now and 9/11 or 2008 is the defense environment. After 9/11, we headed into the Global War on Terrorism (GWOT) and in 2008, the U.S. was deeply engaged in active combat. Neither is true today. At best, we can plan for stable defense budgets, but there is a possibility we may see defense funding diverted to non-defense areas. If this occurs, it would be an unprecedented double shock to the Aerospace & Defense industry.

What are applicable lessons from prior shocks?

While this COVID-19 shock is unique, lessons from prior shocks are relevant. The most important lesson is how companies that took rapid action fared much better compared with those companies that simply “hunkered down.”

Companies that took rapid and decisive action.

Companies that moved quickly—yet in a thoughtful and strategic manner to take necessary actions and make needed cost reductions, rather than across-the-board reductions—fared better. These organizations reshaped and repositioned their businesses to fit the new reality. They right-sized operations and selectively divested assets. They sharply reduced overhead but maintained—and sometimes increased—investments for next-generation programs. Some also pursued acquisition opportunities, obtaining assets and capabilities at low multiples. As a result of these strategic actions, these companies emerged stronger and better positioned than they otherwise would have.

Companies that hunkered down.

Some of these organizations delayed actions in this uncertain period in hopes of a fast recovery, and others took across-the-board cuts, without fundamentally reshaping their businesses, asset bases, overhead cost structures, or portfolios—all moves that could have positioned them to compete better in a new reality. This set of companies fared much worse than the first group, and some ultimately became acquisition targets losing the ability to shape their destinies.

How should companies be preparing for the new reality?

What should A&D leaders be doing next? Companies have already swung into action—assembling teams to manage employee safety and welfare, work-from-home arrangements, etc. Beyond these immediate steps, companies should be considering the following actions to position for coming quarters and potentially longer term:

— Aggressively re-examine the businesses: Run stress tests to identify exposures and the need for cost realignment and cash preservation. Identify opportunities for right-sizing as well as deferring activities, projects, investments, and sunsetting assets (as needed). Identifying supply base risks—they are likely to increase—with potential liquidity challenges at some suppliers. As you evaluate opportunities, we suggest you take a scenario-based approach, factoring in timing and potential economic impacts, mapping scenarios to required mitigation actions.

— Reductions are likely to be required. Do not use a simple “reduction in place” approach to reducing headcount or other costs. Reshape activities, organizations, footprint, and businesses, as required, to right size to the new reality.

— The greatest single cost for A&D companies is typically direct material (procurement and sub-contracts for programs and products). Active management of the supply base and visibility of risks is critical during this time to identify risks (delivery, quality, liquidity, etc.), and prepare for active assistance or interventions.

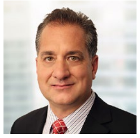
— Identify where and how you need to reposition for the future. Examine where you should restructure the supply base to alternative partners, where needed. Assess how you would realign your cost structure to meet the current reality. Many companies will need to asses business units that might be candidates to divest, as well as examine assets or capabilities you should think about acquiring (if possible) to position for profitable growth in the post-recession world.

It is likely going to take aggressive, rapid and decisive action to get costs realigned, in order to position cost structures, asset bases, supply bases, and business portfolios to weather the storm and be well situated for the next cycle.

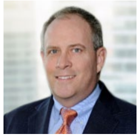
After more than ten years of sustained health in both commercial and defense markets, these actions may feel extreme. But remember: the Aerospace and Defense companies that most successfully navigated prior downturns were better positioned for the next cycle and delivered better shareholder returns during the recovery. These companies took advantage of the opportunity to fundamentally reshape themselves during the inflection points. These companies were able to position themselves for growth in new areas by freeing up investment capacity by keeping an eye to the future for when demand returned—which paid massive dividends after past shocks.

We recognize that these are challenging times for everyone. KPMG wants to re-iterate that we are here for our clients and we are ready to help—whether it is simply answering questions, or being a sounding board for ideas, or rapidly deploying on an engagement (even remotely), with the full force of our firm to help you. KPMG is committed to you, our clients.

Contact us



Jim Adams
National Aerospace & Defense Industry Leader
jimtadams@kpmg.com
310-766-3601



Steve Beckey
Principal
stevebeckey@kpmg.com
310-849-0016

Tom Mayor
Principal
tmayor@kpmg.com
216-496-7485

Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates or related entities.

kpmg.com/socialmedia