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A new cycle begins

M&A in the new aerospace and defense environment

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Big changes are unfolding across the aerospace and defense sector. And that means new approaches to growth — particularly inorganic growth.

Are A&D players ready?

All signs suggest that 2017 will be a pivotal year for the aerospace and defense sector. For commercial aerospace players, recent developments indicate that the golden era of year-over-year, record-breaking order backlogs and build rates may be starting to come to a close. Orders are waning for new aircraft. Production rates, particularly in the wide-bodied segment, are declining. And book-to-build ratios are falling (albeit from historic and unsustainable highs).

While commercial aerospace may be moving towards a down cycle, the defense sector seems to be on the cusp of an up cycle. Having weathered the steep budget cuts from sequestration and troop drawdowns earlier in the decade, there are increasing signs that funding and modernization investment are set to rise.

President Trump's recent proposal suggests that defense spending may see a US$54 billion boost in the FY18 budget, a 10 percent increase over current levels[1]. The administration is also putting pressure on other governments (particularly the NATO members) to increase their defense budget allocations to the minimum targeted spending levels. In addition, the heightened geopolitical risk environment will likely result in higher defense spending in foreign markets despite fiscal challenges and weak economic growth.

[1] NYT: New York Times, *Trump to Seek $54 Billion Increase in Military Spending*, February 27, 2017

A late spring

Normally, this type of cycle change would spark fierce M&A activity as players jockey for position and new strategic investors move into the market. Yet — to date — activity has been notably depressed. And, in the short-term, for good reason.

On the commercial aerospace side, the problem is largely related to the growing valuation gap between buyers and sellers. The sellers that KPMG's member firm professionals work with point to their 8-year order backlogs, ramp up of new platforms and growing production capacity as evidence of their long-term viability to revenue streams and as support for their high valuation expectations. Buyers, on the other hand, see signs of declining new order intakes, rising competition, growing risk for order cancellations and threats to return levels on new original equipment manufacturers (OEM) investment demands as evidence that valuations should be moderating. Neither side is ready to blink.

For the defense side, the near-term challenge is one of uncertainty. The US President's proposed FY18 budget increase is subject to approval by the Congress. How the new administration's priorities on infrastructure and readiness are fulfilled remains to be seen. What is clear is that the Department of Defense's priorities will continue to shift — away from conventional weapons and towards NextGen capabilities and advanced technologies such as artificial intelligence, cyber security, electronic warfare and unmanned systems. The ability of defense contractors to successfully adopt offerings from and/or partner with the commercial sector and Silicon Valley-based high-tech companies to deliver to these evolving demands is yet to be determined.

Looking to a new fall lineup

Don't expect activity to remain muted for long. Indeed, KPMG professionals in the US expect activity to pick up significantly in the near-term. Activity is likely to be unlocked by law makers providing further visibility on program specific funding of government initiatives.

But also expect to see mounting pressure from investors looking for defense contractors to apply growing sums of accumulated cash balances to growth initiatives (preferring long-term shareholder returns over short-term stock buybacks and special dividends). At the same time, activity will most likely be catalyzed by the emergence of lucrative investment opportunities in foreign and cross-sector markets. Also expect to see a renewed private equity interest, driven by robust access to capital, and attractive financing markets, seeking to acquire businesses with high-end capabilities at an attractive point in the cycle.

In the commercial aerospace sector, disparate valuations will likely require innovative deal structures and a more thorough assessment of available synergies to bridge the valuation gap. Furthermore, given the ongoing operational excellence and revenue enhancement initiatives underway at the OEM, it seems likely that we will see more deal-making activity within the value chain as some players consolidate to access differentiating technologies and drive cost savings while others are brought into the in-house supply network.

Going back to summer school

The next few months may be rather stressful for most deal-makers in the A&D sector. Many are already feeling pressure from shareholders to spend some of their dry powder on a headline-grabbing investment. And they recognize that prices for good quality assets are already skyrocketing. But they also know that the risks associated with a major deal are higher today than ever before.

In this environment, KPMG specialists believe that A&D organizations need to sharpen their M&A focus and redouble their deal-making discipline in order to secure long-term growth at acceptable returns on investments. This means taking the time to assess the strategic alignment and leveraging sophisticated techniques to identify and realize long-term value-generation opportunities rather than pursuing acquisitions on a more instinctive basis. And this, in turn, will require M&A teams to think carefully about how their activity furthers the organization's long-term goals.

At the same time, A&D deal making capabilities will likely also need to evolve, in part to reflect a new type of acquisition target — one where intellectual property and talent matter more than assets and inventory. But growth driven A&D players will also likely need to broaden their focus to overseas markets and new innovative capabilities, as well as ability to execute non-traditional M&A transactions e.g., partnerships and alliances, particularly when looking to capitalize on new growth markets and partnership opportunities.

So while the A&D sector may currently be experiencing a bit of a lull in transaction activity, we would suggest that this presents a much-needed window of opportunity for deal-makers and executives to sharpen their capabilities and realign their objectives. The pace is likely to pick up soon. It's time to prepare.

> “In this era of high valuations and limited asset availability, A&D companies need to exhibit strict discipline. They need to adhere to their investment criteria. They need to evaluate the synergies carefully. And they need to conduct robust due diligence to understand how their investments will help achieve their revenue, profitability and cash flow projections.”

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