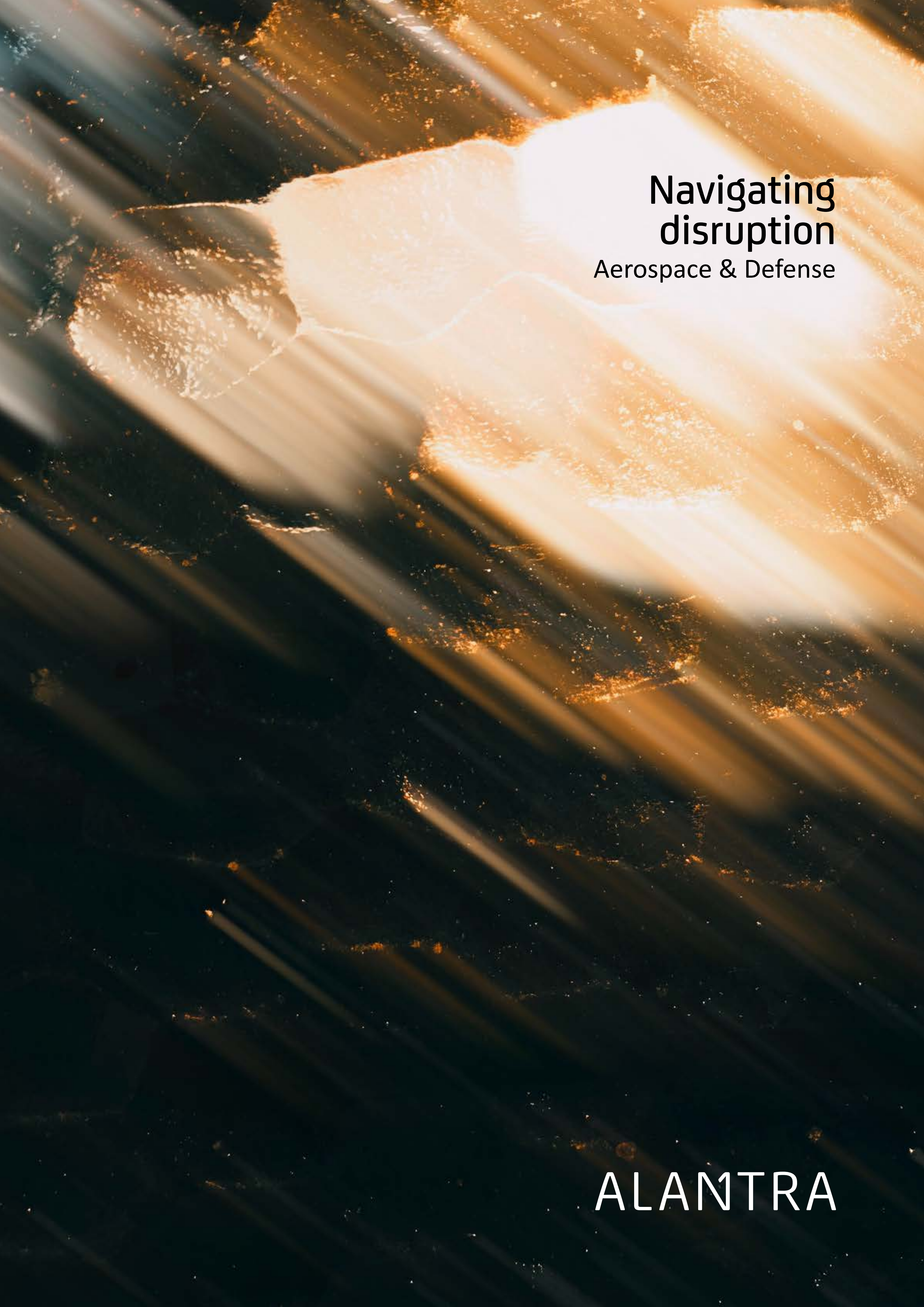


Navigating disruption

Aerospace & Defense

ALANTRA

INTRODUCTION

Geopolitical tensions with Russia and China coupled with President Joe Biden's maintenance of US defense spending drove a record year for mergers and acquisitions in the aerospace and defense industry in 2021. Acquisitions reached $116 billion for the full year, with headline-grabbing deals such as the $8.8 billion takeover of Meggitt by Parker, and Teledyne Technologies' purchase of Flir, Ltd for $8.2 billion. The mid-market also prospered with deals such as CACI's acquisition of SA Photonics for $275 million.

As tensions continue throughout the first half of 2022, world leaders agreed on a series of sweeping changes during the recent NATO Summit in Madrid: to deploy a significant number of troops (approximately 300,000) in Europe, to formally invite Finland and Sweden to join the alliance, and to commit at least 2% of their Gross Domestic Product on defense to ensure the readiness of the alliance.

These new NATO measures force all member states to commit to bolstering their respective defense budgets to be able to continue to support Ukraine and the surrounding countries. The US was also drawn into backing allies such as the Philippines, Indonesia, Malaysia, Brunei, Taiwan, and Vietnam as China built ports and airstrips and deployed fighter jets and cruise missiles to islands in the South China Sea. These measures should lead to continued strong interest in defense-focused M&A opportunities.

Compared to the defense sector, commercial aerospace performance was far less robust in 2020 and 2021 as a result of government curtailments on travel during the pandemic. Thousands of flights were grounded, forcing airlines to cut costs by 34%. Basic part manufacturers of components such as aerostructures, machined, cast and forged parts, and composites were the hardest hit, particularly smaller sized companies, (which make up a large component of the supply base), and those with material or singular exposure to the commercial side of aerospace.

Acquisition activity in this space tends to track air traffic performance. The pandemic has taken a heavy toll on airlines with the International Air Transport Association (IATA) forecasting cumulative losses of $201 billion between 2020 and 2022. It is no surprise that M&A has been muted with buy-side clients deciding to hold off until they have more clarity in their forecasts and sell-side clients waiting to record multiple months' worth of strong earnings and growing revenues now that the commercial sector is starting to quickly recover.

The converging fortunes of the defense and the commercial aerospace sectors open up interesting opportunities, but also sizable risks, for investors and corporates active in the space.

AEROSPACE & DEFENSE

Wade Aust, Partner at Alantra:
"People are seeing the benefit of having exposure to both sides of the A&D space and are trying to build that into their revenue."

Opportunities

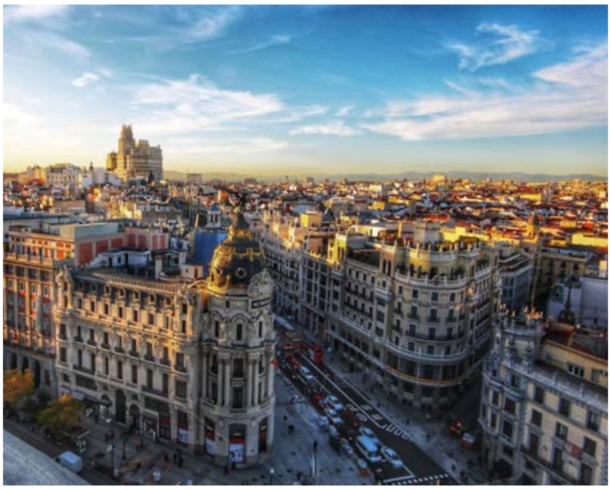
The companies that stand to benefit most in 2022 are those that find an equilibrium between defense and commercial, according to Wade Aust, a partner at Alantra specializing in M&A in the Industrial and Aerospace & Defense Sectors.

"People are seeing the benefit of having exposure to both sides of the A&D space and are trying to build that into their revenue," he says. IATA expects global demand to reach 83% of pre-pandemic levels in 2022, with expected industry losses dropping to $9.7 billion and recouping profitability in 2023.

Air travel recovery is reflected in the growing demand for narrowbody aircraft suitable for domestic flights. Airbus recently told investors it plans to ramp up production of narrow-body planes to 64 in mid-2023, compared to 40 at the peak of the pandemic. Tata-owned Air India is considering the purchase of as many as 300 narrowbody planes in what would be one of the largest orders in commercial aviation history, according to Bloomberg. And Boeing has been slowly whittling down its inventory, which once numbered as many as 450 planes during the pandemic, to less than 100.

Defense spending will remain strong in 2022 as seen at the Madrid NATO Summit. NATO's Secretary General Jens Stoltenberg warned in June that the war in Ukraine could last for years, compelling governments to maintain or increase their defense budgets. Germany, for the first time in many years, has agreed to raise its defense spending to 2% of GDP in response to the Ukraine crisis. The US has sent more than $50 billion in military aid to Ukraine since the Russian invasion began, and its 2022 budget includes orders for additional aircraft, including 12 additional F/A-18 Super Hornets and five more F-15EX jets, both made by Boeing.

Germany has for the first time in many years agreed to raise its defense spending to 2% of GDP in response to the Ukraine crisis. The US 2022 budget includes orders for additional aircraft, including 12 additional F/A-18 Super Hornets and five more F-15EX jets, both made by Boeing.



> There may be a silver lining for M&A, however. Larger, better-capitalized suppliers are now at a point where they themselves are running out of capacity and struggle to maintain lead times.

Risks

The pandemic forced many suppliers to reduce capacity and lay off employees who then moved on to other jobs. It has been difficult for companies to bring back some of their personnel as the ramp-up in production has been faster than expected. The anticipated bottlenecks in the manufacturing sector, as well as in the maintenance, repair, and operations (MRO) sector, have led some companies to pull back on their revenue forecasts for 2022 (and even for 2023) to account for execution risk in meeting customer demand.

There may be a silver lining for M&A transactions, however. Larger, better-capitalized suppliers are now at a point where they themselves are running out of capacity and struggle to maintain lead times. One solution is to control more of the supply chain via acquisitions, giving companies a way to manage their "pinch points" in the production process.

For example, Aust explains, "a company that focuses on machining of parts might try to gain exposure to special processes so that they can control a greater segment of the supply chain and manage those lead times."

On the defense side, while geopolitical tensions may have driven governments to ramp up defense spending, those same tensions have led to more scrutiny with consolidation, especially cross-border deals. The Pentagon said in February that mergers and acquisitions among its contractors pose economic and national security risks for the US. As a result, they laid out steps to block mergers that run contrary to US interests. "In our transactions, we are certainly seeing more scrutiny on crossborder deals with the Committee on Foreign Investment in the United States than in the past," said Aust. In the same month that the Pentagon made its announcement on M&A transactions, Lockheed Martin called off plans to acquire Aerojet Rocketdyne Holdings for $4.4 billion amid opposition from the Federal Trade Commission.

The Ukraine crisis could also have other unforeseen knock-on effects for the aerospace industry. The rise in energy and food costs as well as rising prices on other products, put an abrupt end to the era of negative interest rates and easy money for corporate lending. The combination of inflation, higher interest rates, and a looming recession, has led banks to cut their exposure to leveraged loans, putting at risk $25 billion of deals in Europe, according to Bloomberg.

Valuation multiples averaged
11.4 times EBiTDA in 2021

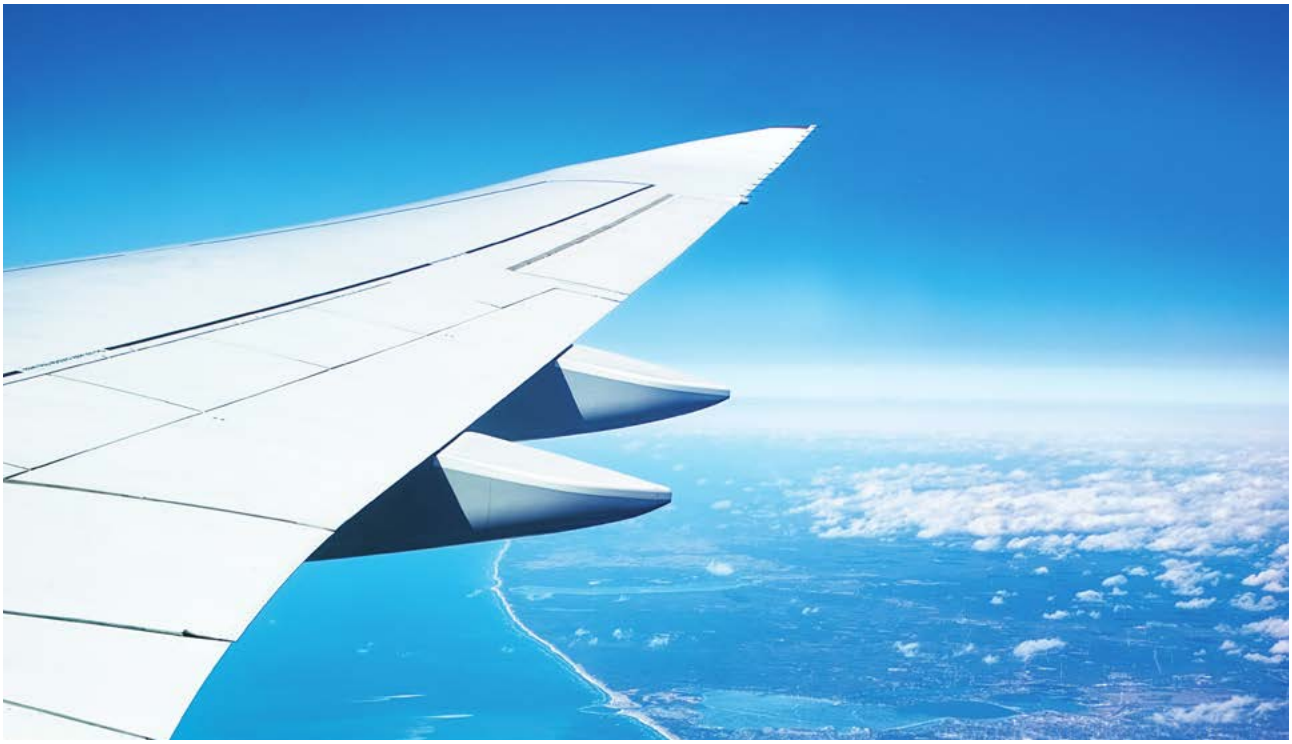
Outlook

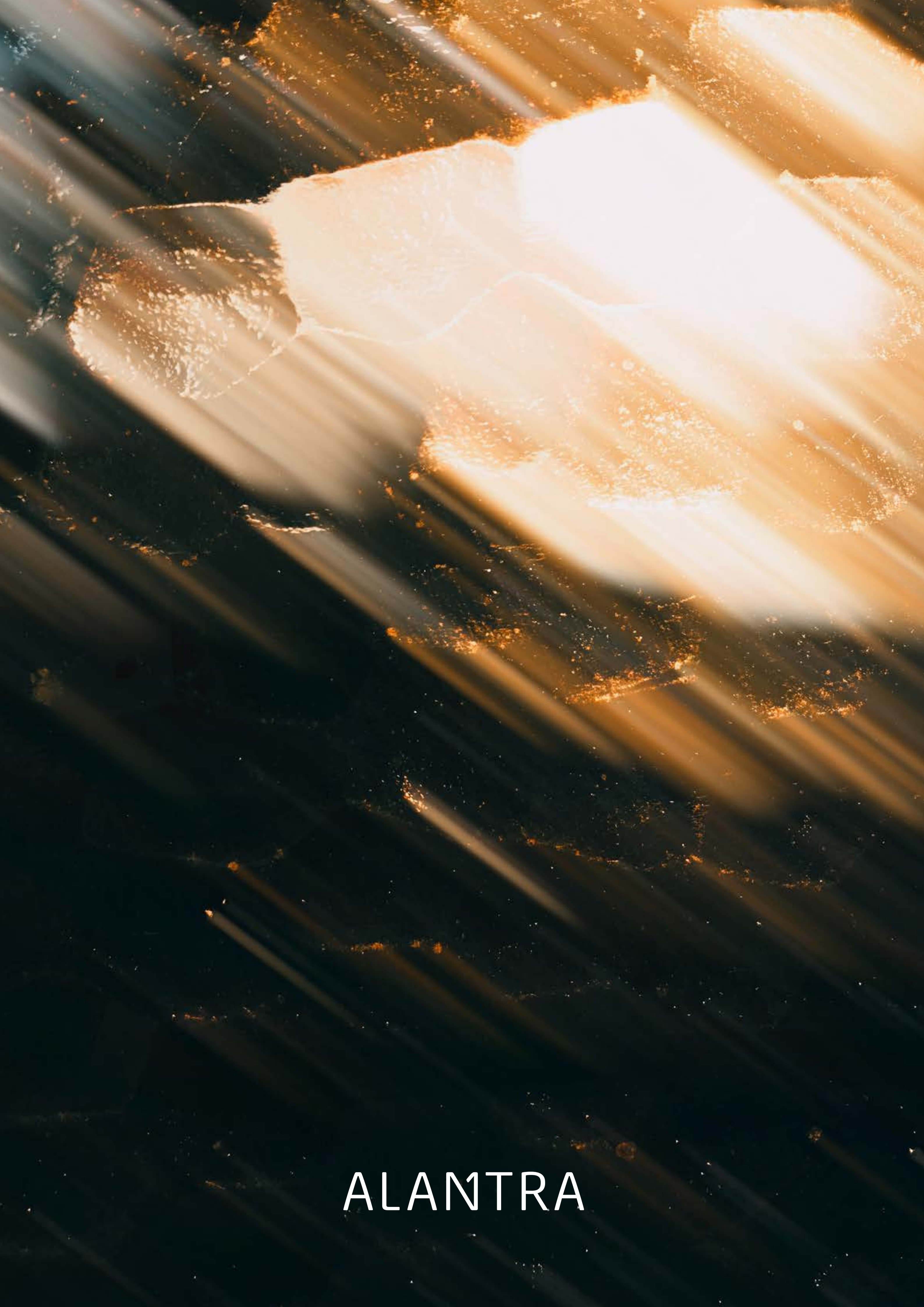
These are unprecedented times. Geopolitical tensions not seen since the height of the Cold War, married with a once-in-a-century pandemic, have rocked the world. But the aerospace and defense industry is well-placed to emerge stronger in 2022.

The signs are that 2022 will follow 2021 as a strong year for M&A in the sector as commercial original equipment manufacturers (OEMs) and MROs bounce back while the defense market holds firm. There are already signs of a surge in capital investment in commercial markets for 2H 2022, as flight activity continues to steadily increase.

Potential sellers who didn't have confidence in the forecasts to go to market last year are feeling more secure about their prospects, while US defense spending will rise after Congress agreed to increase the US budget by $37 billion. There is a lot of money looking to find a home in missile defense and space due to Russia/Ukraine and the potential China threat.

Valuation multiples averaged 11.4 x EBITDA in 2021, and Aust expects overall valuations to remain approximately the same in 2022, although the mix of sectors that outperform is likely to be different. "We will see a flight to quality in 2022, with size and sector exposure heavily influencing valuations as the pandemic recedes," said Aust.




ALANTRA