William Blair

Key Factors Driving Activity in Commercial Aerospace

Despite uncertainties surrounding the commercial aerospace industry over the past 18 months, seller and buyer interest in the sector remains strong. We explore key valuation drivers in the current M&A environment.

Industry Commentary

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As the commercial aerospace sector gradually begins to recover from COVID-19, its highly fragmented supply chain is likely to see a new wave of consolidation. The industry experienced 18 months of major disruptions, beginning with the prolonged grounding of Boeing's 737 MAX jet in March 2019 and followed by the onset of the global pandemic. But opportunistic suppliers and private equity sponsors are increasingly active in the market, seeking to strategically enhance their portfolios with businesses well positioned to benefit from the post-pandemic commercial aerospace rebound.

Many aerospace suppliers reached a trough in their earnings during the pandemic and are now beginning to step up production as OEMs tackle their massive order backlogs. Despite reductions in aircraft production as a result of the 737 MAX delays and COVID, Airbus and Boeing have increased production levels of their narrow-body aircraft in 2021 and future production target rates. Airbus increased its A320 production rate to 45 aircraft per month during 2021 and is expected to continue to ramp up its future monthly production rate to 65 aircraft by summer 2023. Similarly, Boeing increased its 737 aircraft production rate to 19 aircraft per month in 2021 after halting production entirely in 2020, and has increased its monthly production target to 31 by early 2022, representing a 63% increase in expected production.[1] Suppliers are expected to reach pre-pandemic earnings by 2024–2025, when narrow-body aircraft production and global supply chains begin to normalize. As aircraft production ramps up, suppliers will likely encounter increased operating costs and struggle with finding additional skilled labor to increase production capacity. Well-capitalized suppliers are likely to ride low-risk earnings momentum and pursue opportunities that focus on building scale to capture horizontal and vertical leverage. While manufacturers grapple with a global supply crunch and increasing prices for raw materials, suppliers—now more than ever—need to enhance cost-competitiveness through targeted niche capabilities and/or advanced technologies that will drive long-term sustainability.

State of Play in the Skies

Discretionary air travel (domestic and international leisure travel) and business travel have yet to reach their pre-pandemic levels. While the pace of the recovery is still unclear, there are reasons for optimism. Overall global revenue passenger-kilometers (RPKs) are expected to recover to 40% of pre-COVID levels in 2021 and 61% in

1. Sources: Airbus and Boeing Q3 2021 earnings call transcripts via FactSet financial data and analytics

2022, boosted by the global rollout of COVID-19 vaccinations. Domestic travel passenger RPKs are expected to reach 73% of 2019 levels in 2021 and 93% of 2019 levels in 2022. While domestic travel enjoyed a rebound driven by increased leisure travel, international travel and business travel have suffered from low travel volume and slower recovery rates. International travel RPKs are expected to reach 22% of 2019 levels in 2021 and 44% in 2022, representing a more prolonged path to normalized levels.[2] U.S. business travel spend estimates were between 10% and 15% as a share of 2019 spend in the second quarter of 2021, but are expected to be between 65% and 80% of 2019 levels in the fourth quarter of 2022, showing increased confidence in business travel in the near term despite falling short of pre-pandemic levels.[3] The global aircraft fleet is expected to more than double by 2040, led by increased production of single-aisle, narrow-body aircraft as airlines move to relatively smaller jets to ensure seats are filled to capacity. Commercial aircraft production will steadily increase through 2030, when total annual aircraft production is expected to reach 2,275 planes—23% higher than the 1,850 aircraft produced in 2019. As the industry continues to recover, 2021 should see about 386 more planes delivered than 2020's 835, down from its peak of 1,860 in 2018.[4]

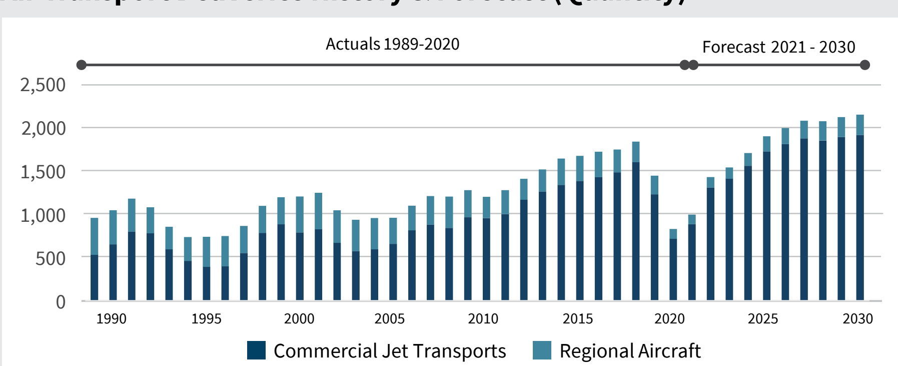
New aircraft programs and platforms have begun ramping up:

- China's new narrow-body aircraft, the Comac C919, is expected to receive certification in 2022. Comac gets 75% of its components from U.S. and EU suppliers.
- Newer joint venture programs are committed to more sustainable air travel, such as GE Aviation and Safran's CFM RISE (Revolutionary Innovation for Sustainable Engines) program.
- Urban air mobility OEMs, which envision an aviation transportation system that will use highly automated aircraft to transport passengers and cargo at lower altitudes within urban and suburban areas, are planning sector routes and conducting testing.

Bright Spots on the Horizon

Much of the industry's newfound confidence is driven by the easing of COVID-19 travel restrictions for international visitors since November as concerns about the Delta variant generally died down. However, the emergence of the Omicron variant continues to hamper airline bookings and has driven major staffing challenges for airlines globally. Despite the rapid spread of the Omicron variant, TSA passenger screening numbers in November and December of 2021 were the closest to 2019 pre-pandemic levels, representing 84% of 2019 November and December screenings and an increase in general commercial air travel. While airlines continue to monitor recent trends, they remain focused on limiting capacity because flying hours have not rebounded yet, which impacts cash flow goals.[6]

Air Transport Deliveries History & Forecast (Quantity)[5]



Despite the prolonged slump in commercial air demand, general aviation (GA), which includes all civil aviation aircraft operations with the exception of commercial air transport, has proved particularly resilient. General aviation rebounded quickly during COVID-19 and has already returned to pre-pandemic levels. In fact, many smaller markets are operating above 2019 volumes as a result of a number of evolving and emerging trends that will continue to influence growth over the near term.

Chief among these trends is an influx of new customers. People are choosing to fly privately for either safety concerns or convenience. Many of these new flyers are remote workers who relocated outside major urban areas during the pandemic and homeowners who have now turned their second homes into their primary residence.

The growth of these two segments—combined with increased regional transportation support for manufacturing, supply-chain management, food production, medical transport, and other use-cases brought on by COVID-19—has increased demand and capacity at GA hubs. The National Business Aviation Association (NBAA) recently advised GA operators to prepare for a busy holiday and winter travel season as they anticipate high volumes of travelers and pre-pandemic-level air traffic.

Four Key Dynamics Driving Commercial Aerospace M&A Activity

Today, the motives behind M&A activity in the commercial aerospace industry exhibit four key factors that can influence buyer interest and valuations. To position themselves to maximize value, sellers should be aware of how buyers view each of these factors.

1. Extent of IP Content

A solid intellectual property stack that protects key product and process innovations is a major factor in current valuations. Buyers typically evaluate businesses in the commercial aerospace sector based on a sliding scale of intellectual property.

2. Source: IATA Economics COVID-19 Airline Industry Outlook October 2021
3. Source: Deloitte Return to a World Transformed: How the Pandemic is Reshaping Corporate Travel August 2021
4. Source: Aviation Week's Airline Monitor 2020 Commercial Market Forecast
5. Source: Teal Group June 2021. NAVEO analysis. Note: This chart was reproduced from the source document.
6. Source: TSA Reported Passenger Screening Numbers January 2022

The following characteristics create a framework for their evaluation:

Value

Low Value	Medium Value	High Value

IP Attributes

Contract Manufacturing/ Build to Print	Build to Spec	Design Ownership and Spec'd in Status
Virtually no IP content - suppliers manufacture to the customer-owned designs/prints and do no unique engineering. Typically have very low margins due to low IP ownership and low switching costs for customers	Typically have some degree of IP content - suppliers understand customer needs and develop solution/design (in conjunction with the customer). Supplier ownership of the tooling, degree of engineering expertise, and sole source content drives valuation higher - companies with higher margins typically have more IP content	Highest degree of IP content - supplier owns the design of the product and is often spec'd into the platform. Customers must use the supplier's design/product unless the platform is recertified

Businesses with significant IP content are attractive because of increased barriers to entry and lack of competitive alternatives for customers. Therefore, businesses with significant IP content are typically higher-margin businesses with significant aftermarket content. Once a supplier with significant IP content gains content on a platform, it is difficult to replace it as a result of its entrenched position with the customer. Although businesses that possess increased IP ownership are typically valued higher than build-to-print businesses, the latter can still generate strong values if they possess differentiated capabilities or specialized manufacturing techniques that are difficult to replicate.

2. Customer and Platform Diversification

Suppliers at the intersection of the commercial, military, cargo, and space ecosystem are viewed as highly attractive targets because of an increase in diversification potential. With a limited number of aerospace OEMs, many businesses in the sector have some level of concentration from a customer perspective. The more diversified a business's customer portfolio is, the higher a valuation it will typically generate. In addition, even if there is significant customer concentration, if a business is able to demonstrate that there are many different decision-makers within the concentrated customer, and therefore different distinct purchasing decisions within a customer, buyers will view the opportunity as more attractive.

In addition, buyers view businesses with platform diversification more favorably. However, although platform diversification is important, the platform mix itself is also an important aspect of buyer's evaluation of a business. Buyers place more value on businesses that are well positioned on aircraft platforms that are expected to generate outsized growth in future production rates and usage. Between 2021 and 2030, more than 75% of projected new aircraft deliveries by quantity will be narrow-body aircraft, led by Airbus's A320neo and A220 and Boeing's 737 MAX. Low-cost carriers, emerging market growth, and replacement of older aircraft are driving much of this demand.[7]

3. Aftermarket Content

Buyers favor businesses with significant aftermarket content. This is because instead of solely being dependent on new production levels, the business benefits from more predictable, ongoing demand. Because parts in the commercial aerospace sector must operate in extremely harsh environments, they must be replaced as a result of both wear and tear and required upgrades to the platforms. This leads to a highly predictable replacement cycle throughout the aircraft lifecycle, which is decades long. Because of the recurring nature of aftermarket content, aircraft platform longevity and future outlook are critical evaluation measures for investors. In addition, businesses with significant IP content will typically have more aftermarket content because it is difficult to replace a supplier with IP that already has platform content.

4. Margin Profile

Typically, businesses with more IP content (traditional IP or process IP) will generate higher margins because of a higher customer value add. Buyers will use the overall margin profile to assess the quality of IP and the importance of a supplier to its customer base. Therefore, businesses looking to sell through an M&A transaction should continue to monitor their margin profiles. Typically, long-term agreements are attractive for long-term revenue visibility but can be a double-edged sword because they prevent price increases and hamper margins. Therefore, it is important to evaluate new business opportunities from a margin perspective if a company is interested in pursuing a liquidity event in the sector.

Strong Future for Commercial Aerospace

A range of considerations are driving market forces in aerospace M&A activity, predicated on the ability to quickly pivot to changing supply and demand trends while balancing longer-term plans for renewal and growth. The commercial aerospace market is poised to increase as commercial aerospace traffic rebounds, which will lead to production increases and stronger margins across the industry. This bodes well for the supplier base since analysts predict 2020 should mark the trough in air transport deliveries. To gain operating leverage in the post-pandemic market, strategic alliances among synergistic targets will collectively shape a stronger business with the potential to win market share and category leadership. In addition, financial sponsors are eager to add platform investments to their portfolios in the sector and benefit from the overall sector rebound.

7. Source: Aviation Week's July 2021 Webinar: OEMs and Suppliers: Resetting the Relationship