Aerospace & Defense

2021: Mid-year update

At of the start of 2021, watchers of the Aerospace & Defense (A&D) industry were focused on the pace of the vaccine rollout and on how fast commercial and business travel would come back after a year of COVID-induced shutdown. While the world's emergence from the pandemic remains ongoing, the latest data indicates that a recovery is strongly underway. How far it will come back, and how quickly, remains to be seen. In the meantime, conditions have created opportunities throughout the sector.

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In the spring/summer of 2020, the pandemic was in full swing. There was no travel at all. Entire fleets were grounded as travelers either sheltered in place or waited to see how the situation would progress.

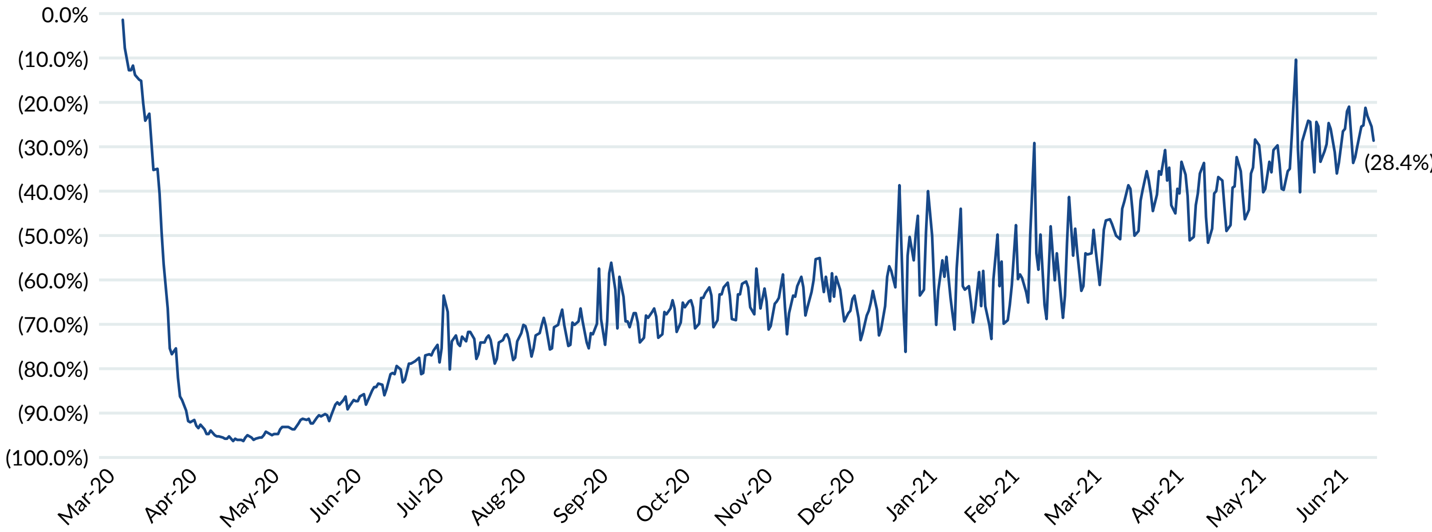
Now, with the vaccine rollout continuing and states eliminating restrictions, the commercial airline industry is showing signs of returning to pre-pandemic levels. Leisure has come back to 75-80% of pre-pandemic traffic. Year-over-year data from Spring 2020–Spring 2021 are largely meaningless; comparisons to the depths of the pandemic a year ago won't really tell us much. Rather, the shape of recovery in commercial travel will be largely reliant on passenger traffic going forward. And on that score, the immediate future looks bright:

- 90% of US citizens intend to fly at some point in the future.
- Almost two-thirds (64%) of the US adult population intend to fly within the next 12 months.
- Nearly three-quarters (73%) of those intending to fly within the next 12 months intend booking at least one month in advance (and much more for some).
- Leisure accounted for more than three-quarters (78%) of proposed air travel.

Source: The Cirium Traveller Intelligence Report 2021 | US Survey

"Now, with the vaccine rollout continuing and states eliminating restrictions, the commercial airline industry is showing signs of returning to pre-pandemic levels."

CHART 1: **PASSENGER TRAFFIC PLUMMETED IN MARCH 2020. A REBOUND REMAINS ONGOING.**



Source: TSA Checkpoint Travel Numbers.

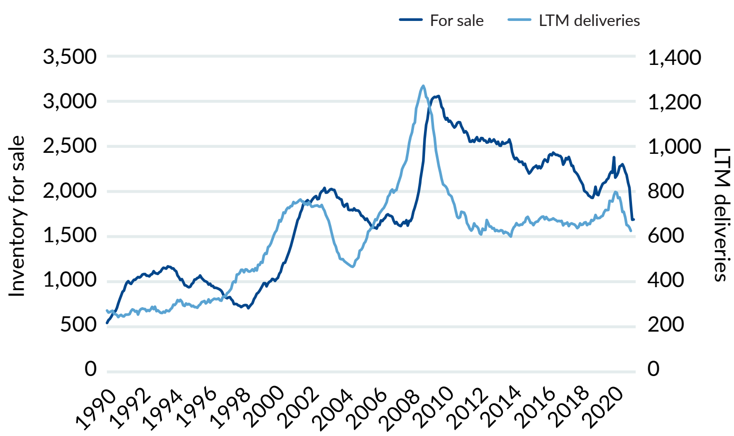
Business travel has come back with surprising swiftness

Business travel has been even more resilient than commercial and far more resilient than people expected. At the height of the pandemic, travel restrictions forced even HNWIs and C-level executives to conduct business via video platforms, and it's possible that some may choose that option more often in the future. However, we don't think we'll go to a world where most business meetings will be conducted over Zoom. When complex deals must be negotiated, we believe players will still prefer to work out the details face to face. The latest data bears that out: according to Goldman Sachs, business jet activity in the United States at the end of March 2021 was nearly 90% of 2019 levels, while activity in Europe remains closer to 70% due to continued travel restrictions.

In addition, the level of used inventory available for sale has declined sharply to levels not seen since the mid-2000s.

Of course, the business sector does face headwinds. Some meetings may now take place remotely that before the pandemic might have prompted a trip. The return of commercial travel offers another option. That said, we are bullish on business aviation, and we believe business jet prospects are attractive at least for the mid-term.

CHART 2: **USED AIRCRAFT INVENTORY IS DECLINING, SETTING THE STAGE FOR MORE NEW JET ORDERS**



Source: Cirium, JETNET.

Production shutdowns boosted MRO firms

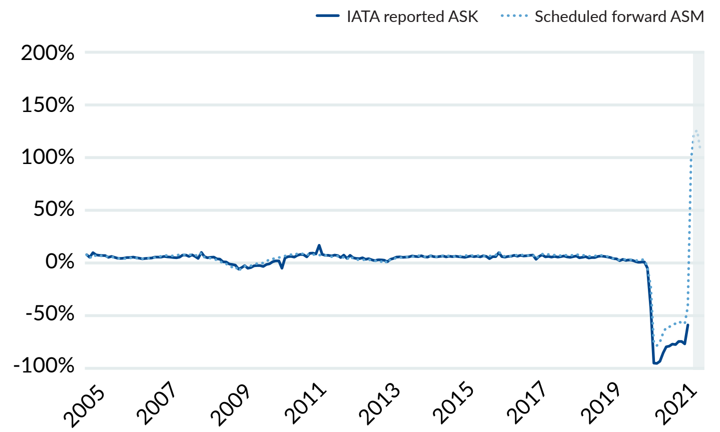
Firms focused on maintenance, repair and overhaul (MRO) typically operate in a "steady state" environment, with original equipment needing refits on a fairly set schedule. However, a couple of significant but unrelated factors set the stage for them to become more vital to global air fleets. The first was when Boeing 737 Max production was frozen. That resulted in other narrow body aircraft getting more hours, which meant increased maintenance and more need for spare parts. The second, obviously, was the COVID pandemic and the damper it placed on global OEM production. Now, as traffic has started to pick up, the MRO segment is recovering faster as airlines rely on fewer aircraft to handle more routes. As airlines return to profitability and business travel picks up, we expect acceleration in MRO profits and consequent M&A activity in the next couple of years, both as a function of needed repairs and of aftermarket replacement parts.

For airlines to be profitable and to order planes and parts, they have to run at a certain capacity. Indications are that capacity is set to improve substantially.

After 1–2 years, the increased reliance on OEM to keep fleets meeting demand should return to the mean in the US. The 737 is back on delivery schedule. That should alleviate pressure on aftermarket solutions and we expect demand to moderate. The important thing is that overall fleets continue to grow, and while temporary setbacks have impeded production, inventories continue to decline.

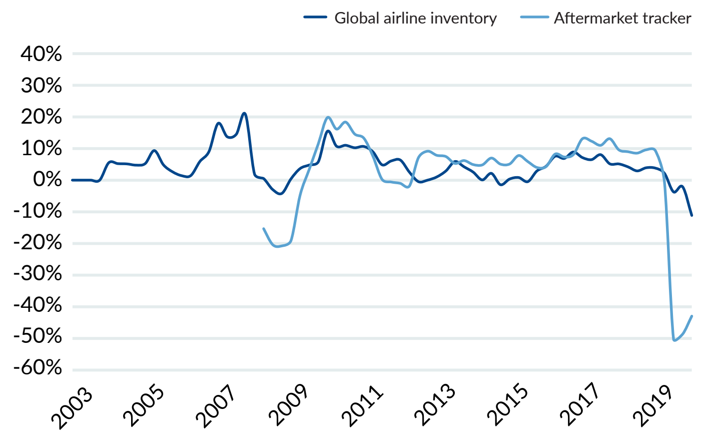
From the standpoint of private equity firms, many are recognizing the opportunity created by the increased reliance on existing jets and are consequently focusing on companies that produce aftermarket parts and perform MRO work.

CHART 3: **GLOBAL AIRLINE FORWARD CAPACITY SET TO IMPROVE SUBSTANTIALLY**



Source: OAG Analyser (May 2021).

CHART 4: **GLOBAL AIRLINE INVENTORY HAS DECLINED BUT IS SUBSTANTIALLY LESS THAN ASM**



Source: Company data, Goldman Sachs Global Investment Research (C4Q20).

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Defense shifts from hardware to "force multipliers"

Acquirers have also been looking closely at defense suppliers. Despite the pandemic, companies involved in manufacturing components considered "mission critical" for national security operations saw very little cut back – in a sense, for these companies, shutting down was not an option. M&A activity remained constant because for them it was business as usual. The resilient nature of such "can't do without" firms was the primary driver of defense sector activity.

For other areas of the defense sector, Biden's recent budget helped clarify where opportunities would be most plentiful in the near term. Overall, we believe the budget is a positive for defense, albeit with a shift in areas of emphasis.

US defense spending over the intermediate term now appears focused more on peer threats rather than terrorism. That foretells growth in so called "force multipliers": cyber securities, C4ISR (intelligence, surveillance, reconnaissance) and missile defense due to threats from North Korea and Iran.

The budget focuses less on new aircraft/tanks/ships and more on sustaining and getting additional mileage out of the tools we already have. For example, retrofitting B52 bombers and U2 high-altitude spy aircraft, and upgrading/refitting legacy systems. We believe this emphasis on "everything old is new again" will likely drive a significant share of M&A in the defense sector.

Another winner in the Biden budget echoes the theme of refurbishing dated systems: retrofitting nuclear deterrent systems and sustaining them.

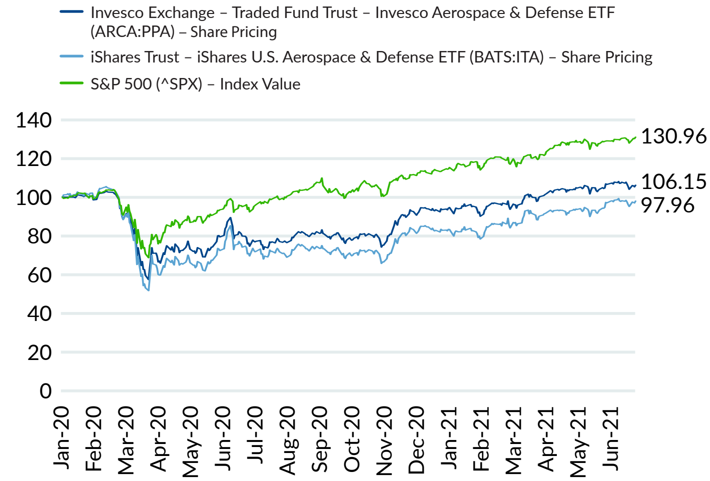
And finally, the budget accelerates spending on space-based surveillance, hypersonic weapons and defense, and R&DTE (research and development, testing and evaluation).

M&A Overview

As we pointed out in our last update, the pandemic effectively suffocated M&A activity in the A&D sectors throughout most of 2020.

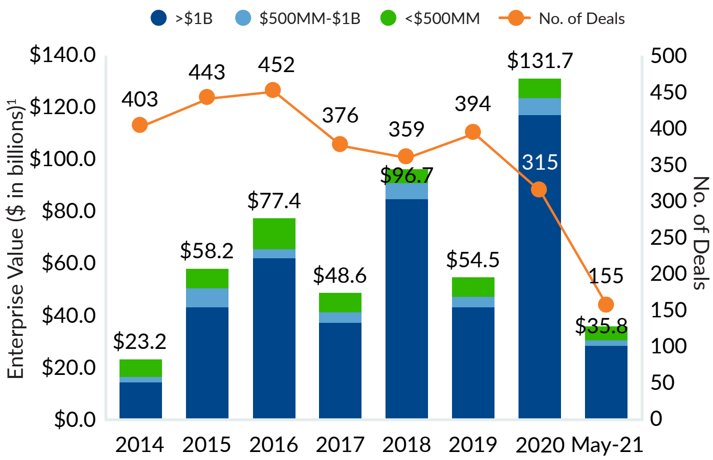
The reduction of M&A activity during the pandemic was not only understandable but expected. None of us had been through anything like it. However, while COVID-19 derailed commercial aerospace deals in 2020, defense continued to be strong. Overall, the industry saw record deal values and volumes in 2Q2021, continuing a positive trend since 2Q2020. While that blistering place relented in 2Q2021, we anticipate continued recovery in 3Q2021.

CHART 5: THE AEROSPACE & DEFENSE SECTOR STILL HAS GROUND TO MAKE UP VERSUS THE OVERALL MARKET



Source: CapIQ as of 6.24.21. Past performance is not indicative of future results.

CHART 6: M&A ACTIVITY WAS STIFLED BY THE PANDEMIC LAST YEAR BUT IS REBOUNDING NICELY IN 2021



Source: S&P Capital IQ.

SPACs dominating big deals

Three of the largest transactions in 1H2021 were urban air transportation companies merging through a Special Purpose Acquisition Company (SPAC). SPAC deals have started to permeate the landscape and will likely continue their presence for the near term. Four out of the top 10 A&D deals in 1H2021 were SPAC transactions.

We expect mergers and acquisitions and consolidation to accelerate during the short/mid-term as the last 12 months was a tough time to sell or maximize value. Buyers have been willing to overlook last 12 months performance and focus on the future, if they can bridge the expectation gap of value and asking price.

Notable transactions

Teledyne Technologies Incorporated announced the successful completion of its acquisition of FLIR Systems, Inc. on May 14, 2021. FLIR will now be included in Teledyne's Digital Imaging segment, operating under the name Teledyne FLIR. Teledyne FLIR will provide a full spectrum of imaging products and assist with the development of a range of unmanned systems.

FLIR stockholders received $28.00 per share in cash and 0.0718 shares of Teledyne common stock for each FLIR share, implying a total purchase price of approximately $57.40 per FLIR share based on Teledyne's closing price on May 13, 2021. Aggregate consideration for the transaction was about $8.2 billion . The acquisition is expected to be immediately accretive to earnings and accretive to GAAP earnings within the first full calendar year after acquisition.

After the "reboot," the market outlook appears positive

Those of us who have worked in the aerospace deal-making realm for a while are aware of the sector's cyclicality. Every 7–10 years, the industry has tended to undergo a correction and then retrench for another strong growth period. Before the pandemic, the sector had enjoyed a growth trend that had been in place since 2008-2012, and we market watchers had been anticipating a downturn. If there's a silver lining for the aerospace industry in the widespread tragedy of COVID, it's that it acted to reboot a market we were already nervous about. From here, passenger demand for flights should improve and demand for planes should begin an extended upward trend.

In fact, there's a strong case to be made that major carriers may in the end emerge stronger. Before the pandemic, OEMs still had years of order backlog. There is a years-long period between when a plane is ordered and when it is delivered. Even when there are cancellations by major carriers, the slack is picked up by companies lower in the pecking order. Production essentially stalling for 12 months may provide more robust demand for several years.

It's also important to remember that airlines are run by leasing companies. After a lease is up, there is still residual value in the aircraft. For that reason, major carriers can recoup some costs, and junior carriers can continue to meet demand with the help of MRO companies.

And one last bright spot: President Biden and European Union leaders recently suspended Boeing/Airbus subsidy tariffs, which should help normalize pricing.

From what we're hearing in talking to private equity firms, investor and business leaders, we're now emerging from the darkness brought on by COVID. The next few years, barring a surprise on the pandemic front or a negative global exogenous factor, look very positive from here on the M&A front.

Dedicated advisor to the Aerospace & Defense sector

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