Aerospace & Defence Update

10 years consolidation: Fewer, larger and more integrated players

Industry Overview

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Equity
Europe
Aerospace & Defence

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A&D: Aerospace & Defence

IP: Intellectual property

Fewer, larger and more integrated firms vs 10Y ago

This week we look back 10 years and discuss the consolidation that the A&D industry has experienced over the last decade. The conclusion looks clear to us: the A&D sector has experienced a decade of significant consolidation to build a group of super tier 1 suppliers. As a result, the average market cap has increased materially (c.100%) and the number of public listed names has reduced, especially among lower tier European suppliers, despite also having seen new listings across both the EU and US. Tier 1 suppliers have been actively acquiring small firms over the last 10 years through a wave of vertical and horizontal consolidation. In our view this means super tier 1 names will have more bargaining power with OEMs for the next gen aircraft in the 2030s.

What does it mean for the industry?

The consolidation of the industry has important implications for the super tier 1 suppliers, OEMs and their supply chains, for the next generation of product development and ultimately for investors as well. To us, a more consolidated industry should pave the way for margin expansion of the super tier 1 names mid-term due to increased bargaining power (higher pricing power), larger scale (economies of scale = op. leverage), and more control over their supply chains (higher levels of vertical integration and scale means more control over the different elements of the value chain and better access to labour).

Suppliers building out capabilities for the next cycle

M&A in the industry has continued, with Safran buying Collins Aerospace's actuation and flight control business from RTX in 2023 and Thales acquiring Cobham Aerospace Communications. We think companies are clearly thinking about the future of product development and technologies that will be core to improving fuel burn, connectivity, electrical power systems etc. We expect these trends to continue over the next few years. Scale will also help from an investment perspective, as R&D and CapEx accelerate towards the end of the decade. The investment cycle from the last product cycle materially impacted cash conversion, and increased scale, and leverage across the business could reduce a degree of that cyclicality of certain products i.e. engines.

Consolidation has been more pronounced in Europe

When comparing Europe vs US, we observe that the consolidation around super tier 1 names has been more pronounced in Europe than in the US. The civil vs defence split has not changed materially in the US. However, European names have increased their exposure towards defence. We believe this has been driven by i) Defence divisions of the key suppliers seeing strong growth while Civil revenues are still depressed vs pre-pandemic levels ii) Management teams have looked to diversify away from pure civil exposure to stabilise the strong cash flow cyclicality of Civil.

Refer to important disclosures on page 7 to 9.
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Fewer, larger and more integrated players vs 10Y ago

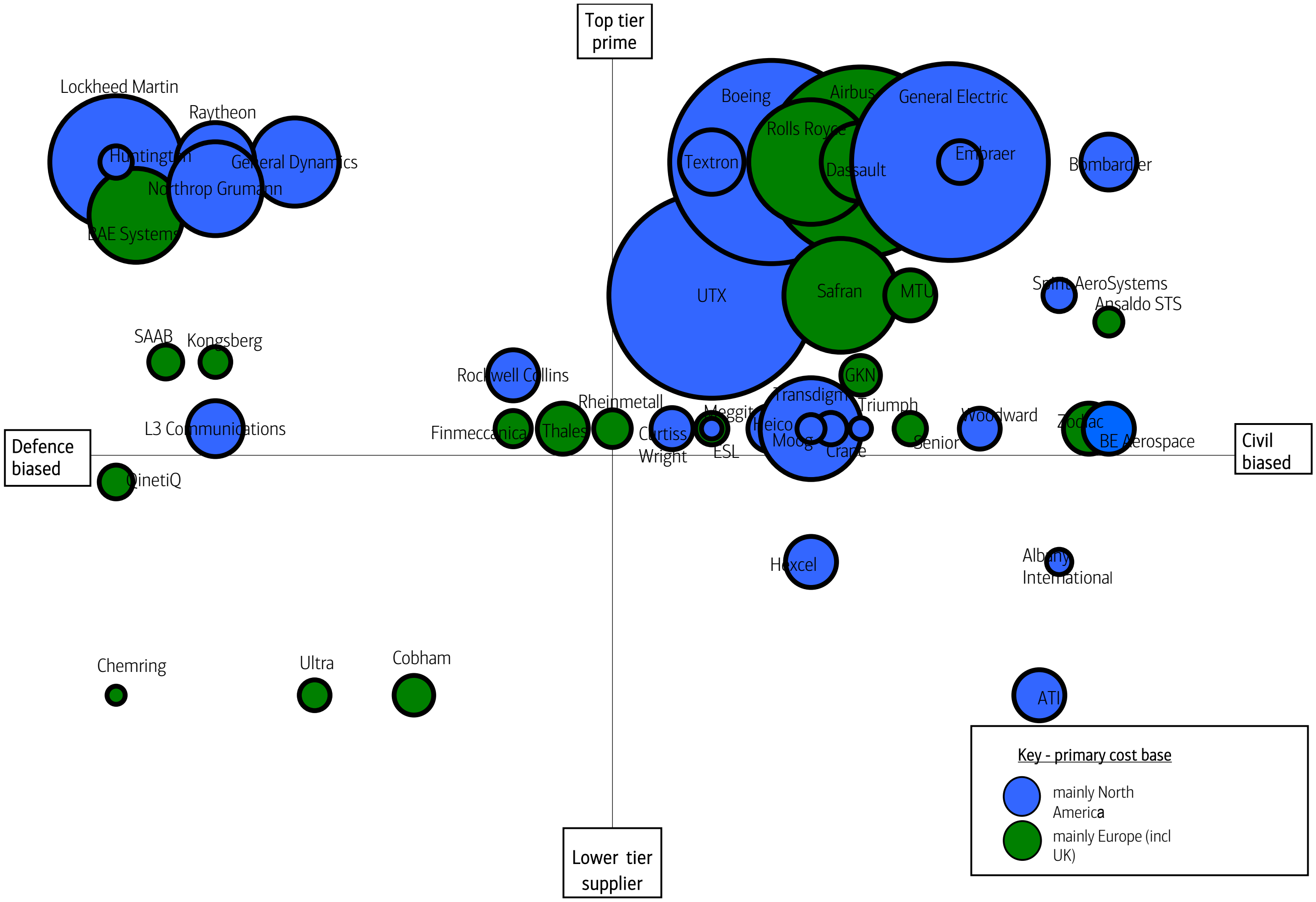
This week we look back 10 years and discuss the consolidation that the A&D industry has experienced over the last decade. The conclusion looks clear to us: The A&D sector has experienced a decade of significant consolidation to build a group of super tier 1 suppliers. As a result, the average market cap has increased materially (c.100%) and the number of public listed players has reduced, especially among lower tier European suppliers, despite also having seen new listings across both the EU and US. Tier 1 suppliers have been actively acquiring small players over the last 10 years through a wave of vertical and horizontal consolidation. In our view this means super tier 1 players will have more bargaining power with OEMs for the next gen aircraft in the 2030s.

>45 public A&D listed firms in 2014

10 years ago, we were able to map >45 A&D public listed companies across EU and US. From these 45 companies, >30 had a market cap of <$10bn (exhibit 1).

Exhibit 1: 2014 A&D sector map (x-axis = defence/civil exposure split, y-axis = supply chain position, bubble size = market cap, colour key main cost base region

The A&D industry was very fragmented in 2014 with > 45 public listed players. From these players, >30 had a market cap of <$10bn



Source: BofA Global Research estimates *General Electrics market cap adjusted as per Aerospace contribution to revenues

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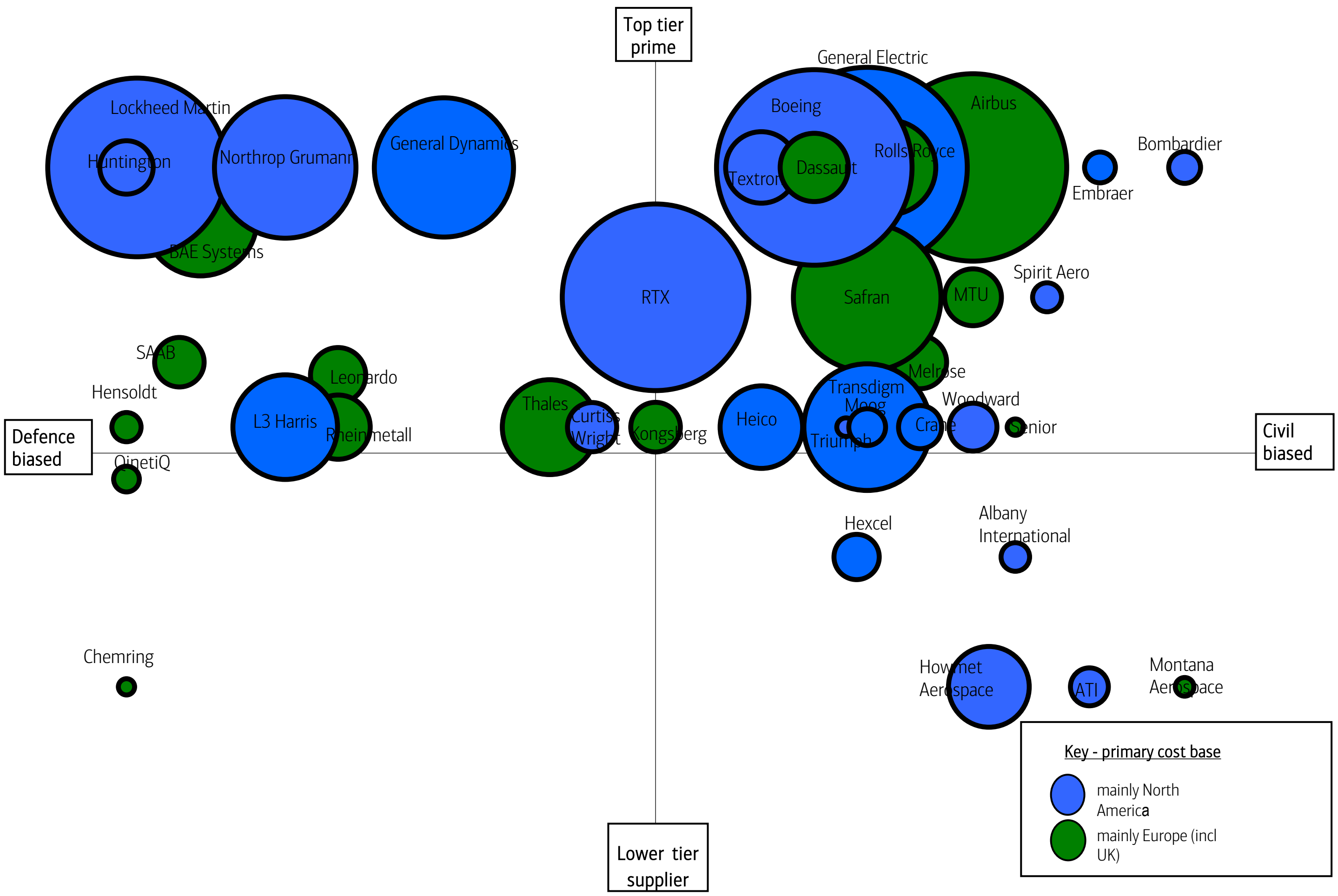
Average market cap has increased c.100% in 10 years

Exhibit 2 shows the significant consolidation process the A&D industry has experienced through the last decade. As a result, the average market cap of A&D firms has increased materially. This consolidation process has been primarily driven by super tier 1 suppliers acquiring smaller players (i.e. Safran's acquisition of Zodiac). However, PE firms have also taken private some small to medium size players such as Ultra & Cobham. As a result, the number of public listed A&D players has reduced vs 10 years ago even if we have seen listings of small players such as Montana Aerospace (2021) or Hensoldt (2020).

When comparing Europe vs US, we observe that the consolidation around super tier 1 players has been more pronounced in Europe than in US. The civil vs defence split has not changed materially in the US. However, European names have slightly increased its exposure towards defence. We believe this has been driven by i) Defence divisions of the key suppliers seeing strong growth while Civil revenues are still depressed vs pre-pandemic levels ii) Management teams have looked to diversify away from pure civil exposure to stabilise the strong cash flow cyclicality of Civil.

Exhibit 2: 2024 A&D sector map (x-axis = defence/civil exposure split, y-axis = supply chain position, bubble size = market cap, colour key main cost base region

The A&D industry has consolidated around super tier 1 suppliers through the last 10 years.



Source: BofA Global Research estimates

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Implications of a more consolidated industry

To us, the consolidation of the industry has important implications for the super tier 1 suppliers & their supply chain, new product development and ultimately investors. In our view, a more consolidated industry should pave the way for margin expansion at the super tier 1 players mid-term due to increased bargaining power (higher pricing power), larger scale (economies of scale = op. leverage), and more control over their supply chains (more vertical integration and scale means companies have more control over the different elements of the value chain and better access to labour which has been one of the biggest issues for smaller companies). We see risk tier 3/4 suppliers with little IP in their products will face an increasingly difficult outlook mid-term to compete against larger and more integrated players. Mid-term we believe this should weigh on the ability of small suppliers to expand margins and generate cash.

Super tier 1 suppliers over time = less supply chain disruption

The A&D industry has historically faced significant supply chain problems due to an extremely complicated supply chain structure. The focus from the OEMs in the product cycle of the 2000-2015 period was to carve out more of the aircraft structures and systems to the supply chain and focus on return on net assets. Over time this has arguably added complexity and in our view resulted in multiple execution challenges across the industry. Labour has been one of the key challenges the industry has faced in the post COVID ramp up, with these challenges much more acute at smaller suppliers.

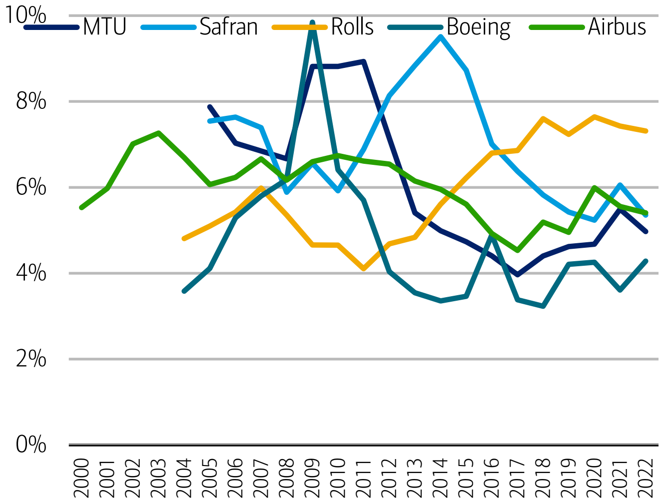
Super tier 1 suppliers should gain bargaining power

The bigger the companies are, the greater their power to push back on pricing. It is well known that both OEMs cascaded challenging pricing and payment terms down through the different levels of the supply chain 2010-19. The emergence of super tier 1 suppliers provides more bargaining power against those challenges conditions and should be supportive of margins and cash generation of the supply chain mid-term.

Suppliers building out capabilities for the next cycle of product development

M&A in the industry has continued, with Safran buying Collins Aerospace's actuation and flight control business from RTX in 2023 and Thales acquiring Cobham Aerospace Communications. We think companies are clearly thinking about the future of product development and technologies that will be core to improving fuel burn, connectivity, electrical power systems etc. We expect these trends to continue over the next few years. Scale will also help from an investment perspective, as R&D and CapEx accelerate towards the end of the decade. The investment cycle from the last product cycle materially impacted cash conversion, and increased scale, and leverage across the business could reduce a degree of that cyclicality of certain products i.e. engines.

Exhibit 3: Total R&D (self + customer funded) as % of sales
Increasing levels of R&D are linked to new product developments. This usually on weighs on FCF conversion & op. profit margins



Source: BofA Global Research estimates

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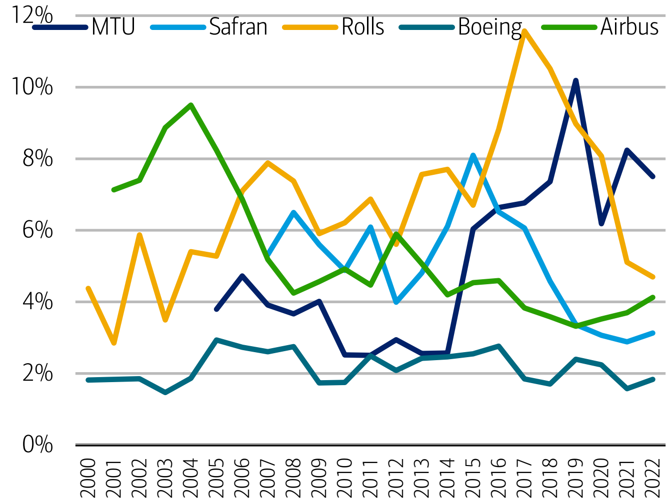
Exhibit 4: Capex as a % of sales 2000-2022
We observe an uptick in CapEx as a % of sales when new programs are being developed



Source: BofA Global Research estimates

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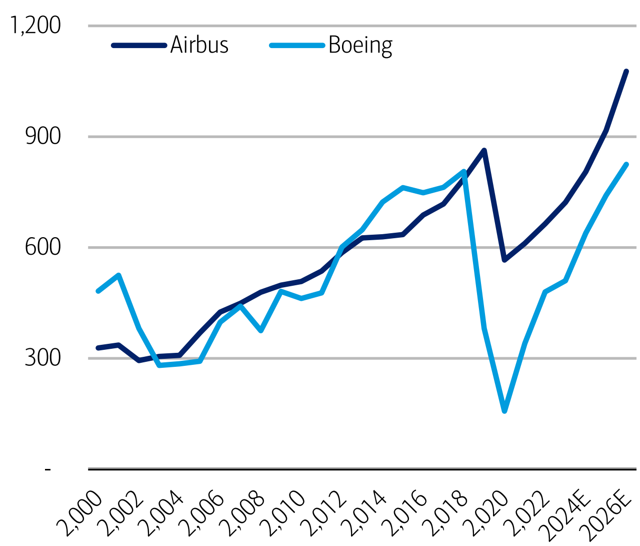
Exhibit 5: Airbus & Boeing production
We see a strong recovery of production across both airframe OEMs



Source: BofA Global Research estimates

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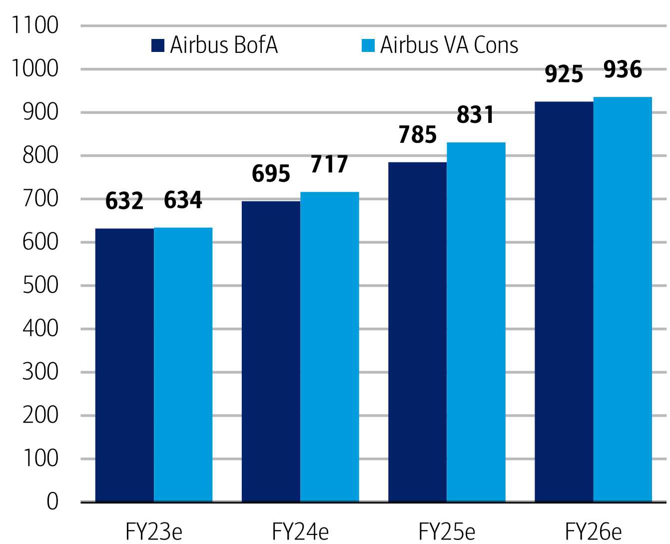
Exhibit 6: Airbus Narrowbody delivery expectations
We are broadly in line with consensus delivery expectations through 26



Source: BofA Global Research estimates, Visible Alpha

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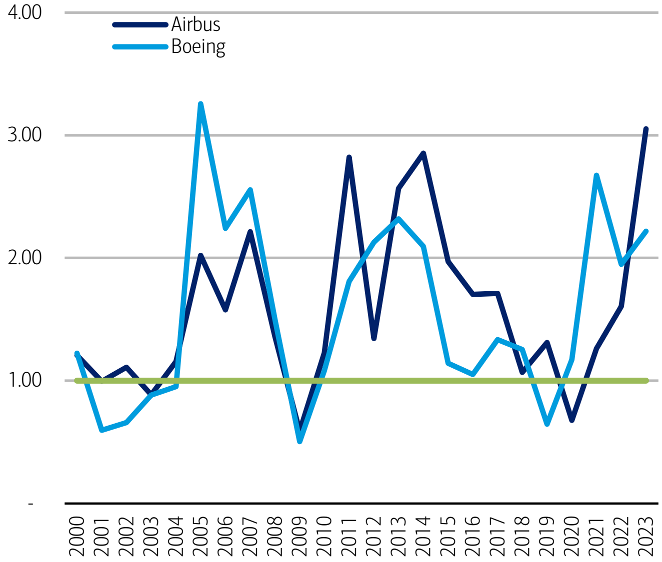
Exhibit 7: Airbus & Boeing Book to Bill ratio
5 Years since 2000 have seen sector book to bill < 1x. 2001-03, 2009, 2020.



Source: BofA Global Research estimates

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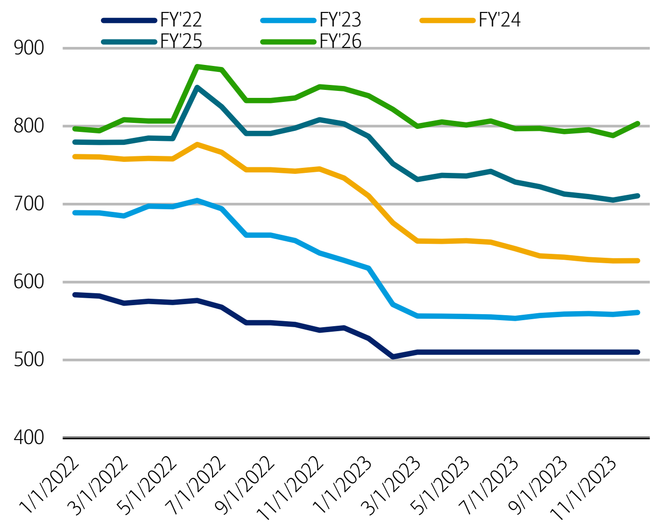
Exhibit 8: A320/A321 Delivery expectations
Delivery ramp expectations have been reset from a front end loaded ramp to a steadier increase in production through 2026



Source: BofA Global Research estimates, Visible Alpha

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Underperform	N/A	≥ 20%

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