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Private Equity Pushes Into Aerospace And Defense

By Michael Bruno

Cobham Aviation Services took delivery of an Embraer 190 in Australia last year. It and the rest of the UK-based division belong to PE-backed Draken now. *Credit: Cobham*

The stark reality of losing two years' worth of commercial aircraft production over the next half-decade continues to weigh on industry as it becomes clear there will be no snap back to prepandemic air traffic levels.

Shares of publicly traded aerospace and defense (A&D) companies worldwide lag their stock market indexes by 26% year to date, Vertical Research Partners said Oct. 16. The laggardly public performance shows how few outsiders—except for people who love to fly—want to be involved with the industry right now.

- After a springtime pause, private equity investors return with a vengeance
- The push into A&D could herald several changes for industry

Few, that is, except for a growing cadre of private equity (PE) investors.

"There are a lot of private equity players that are very interested in what is going on and see an opportunity to buy into the aerospace supply chain," Scott Thompson, PwC's U.S. aerospace and defense leader, tells Aviation Week. "There's a ton of interest. I've got quite a few reach-outs from PE saying, 'Hey, if you can help us identify companies looking for capital, we are eager investors.'"

Thompson is far from alone; headhunters, lawyers, acquisition deal-makers, investment bankers and industry advisors all report noticeable jumps in PE interest in A&D as the pandemic and its economic fallout rolls through industry. "Private equity group percentages have been increasing over the years, and I suspect they will continue increasing," says Stephen Perry, managing director at Janes Capital Partners.

Some recent deals punctuate the observation. In late September, Blackstone Group's Draken International bought 13 aviation service businesses of Cobham Group, which Advent International had taken private just last year and now is breaking up. In another deal unveiled in late September, Delta Tucker's DynCorp International, a provider of military logistics and aviation services to federal agencies, will be acquired by Amentum Holdings in a deal expected to close by year-end.

AE Industrial Partners is one of the leading PE groups active in A&D over the last 3-4 years. AE Partner Kirk Konert says now that industry has entered a down cycle, his firm sees an opportunity to look at companies with more limited competition in the middle-market space.

"This is an industry that we have a lot of passion for, passion for the longevity of the sector," Konert says. The long-term business case remains intact, and veteran A&D PE investors such as AE have tried to stay disciplined with the prices they pay for acquisitions. "I don't think we're going to get better deals—we're going to continue to pay the same prices we were paying—but maybe have more opportunities and more assets" to consider, he said in late July.

Many observers predict private equity's growing presence in A&D could bring many changes to the industrial base. From consolidation of the supply chain to moving production to new locations to accelerating automation, robotics and other digital technology adoption, PE owners are expected to alter the slow-changing A&D industrial base.

But PE may not be satisfied with just the midtier and below: Speculation over PE involvement with OEMs and Tier 1 providers—whether on individual programs such as a new midmarket aircraft or new aero engines—remains a staple of industry water-cooler talk.

"They're probably going to move more from a sector participant to a strategic partner," says Alex Krutz, managing director of consultancy Patriot Industrial Partners. "They typically haven't been viewed by the OEMs, or Boeing for that matter, as partners, and I think that with their liquidity and financial capabilities, we're going to start to see them move into design."

"We're being contacted on a consistent basis by investors looking for resiliency in A&D investments, and military for now looks like the place getting the most attention," says Paul Weisbrich, managing director of the Investment Banking Group at D.A. Davidson. Foreign military sales, which saw a record government-approved $83.5 billion value in fiscal 2020, is one trend to ride. But he says buyers need to be discriminating within defense investments and focus on 2022-23, for instance, looking beyond 2021 for which the defense budget is already set.

Others concur. "I do really continue to see opportunity," says Chris Celtruda, managing principal of Destiny Equity Partners. He cites Pentagon mandates around hypersonics, unmanned aircraft, microelectronics and space driving long-term value in related assets, as well as for modernization and sustainment of aging but critical military systems such as aircraft. Privatization of pilot training is another opportunity as the armed services consider outsourcing the task for cost savings and readiness reasons.

But while the military field is attractive, seasoned investors note the need for diversification across A&D and avoidance of getting caught up in one niche that has performed well over the last six months. "This cycle is a reminder of why platform and market diversity has always been a cornerstone of investing in aerospace and defense," said Paul Teske, a co-founder and partner at ATL Partners, at an A&D Forum event on PE investing in October. "The growth of commercial in the last five years has made some people forget about that."

Weisbrich also recommends space-related opportunities, including supply chain. "That's really the hot topic zone for us today, is space," he says. But again, Celtruda and Teske urge discrimination. Celtruda says space is a tale of two cities: the commercial side of space, while it receives lots of news coverage, is driven by billionaires, and the business models remain to be proven. But government-based work in launch, low-Earth-orbit (LEO) satellites, clandestine intercept and other projects shows genuine opportunity.

Teske noted that among three space sectors—military, civil government and commercial—defense looks the best long term. Others agree.

"Today we see a combination of the two, and really it's a question of the sustainability of one over the other," agrees Tracy Glende, CEO of Valence Surface Technologies. His company does commercial launch vehicle work for SpaceX, Blue Origin and others, but it is satellites for government use that he believes will be higher-margin, more sophisticated and sustainable work. "A lot of these small LEO satellites have cheaper components. We've already seen OneWeb go bust," he notes. "Yes, you can provide internet service to Central Africa, but who's going to pay for it?"

In commercial aviation, many observers advocate more of a wait-and-see approach. Several participants at the A&D Forum event said they expect commercial aviation activity to truly bottom out between now and February. "You are not going to get rewarded for going too early in a cycle if things are still declining," said Teske. "We have a lot of debate [as to] where the dust will settle first, aftermarket or OEMs."

Bryan Perkins, founder and CEO of Novaria Group, suspects there are leading indicators of business activity of which commercial aircraft and engine OEMs are aware but that are not as visible to suppliers. The list begins with the amount of backed-up inventory in commercial aerospace and its consequences.

"I think OEMs are struggling to understand what a supplier sitting on two years' worth of inventory in their own business, coupled with maybe three years of inventory at the OEM, is going to be faced with and how that is going to impact the supply chain in total," Perkins says.

There are also challenges with how cost curves have to change as work volumes drop so much for so long, bringing concurrent pressure on suppliers' working capital accounts. "We're in the second inning of a nine-inning ballgame," Perkins says. "The supply chain is in an every-man-for-himself situation because the OEMs are exhausted."

Glende echoes Perkins and notes how OEM and upper-tier supply chain squeezes of recent years, including should-cost contracting, were predicated on production volumes increasing. "There's a whole set of assumptions behind those programs that all arrows pointing north, and they point north with a rapid acceleration," he says. "They are no longer true."

With Airbus seen as generally better positioned than Boeing, insiders acknowledge the attractiveness of boosting business with the European OEM. Weisbrich predicts more cross-fertilization of suppliers to Airbus and Boeing within five years. But Perkins thinks U.S. PE investors may have to become more active in Europe if they want to play into Airbus' supply chain, because protectionist economic policies may make transatlantic trade harder, and others concur.

"It's going to be more challenging to be a part of that supply chain unless you're physically on the ground in Europe, with a management team in Europe that can help drive that growth and take advantage" of Airbus' A220 and A321XLR, Glende says.

PEs fall within a category of merger and acquisition (M&A) deal-makers known as financial sponsors. The other side, "strategics," are A&D companies, although since late last year their deals predominantly have been divestitures—i.e., OEMs, primes and "Super Tier 1s" shedding noncore businesses.

Top Private Equity Buyers

Company	A&D Acquisitions Since 2017
AE Industrial Partners	26
ACP	21
The Carlyle Group	16
The Jordan Co.	9
Acorn Growth Cos.	7
Veritas Capital	7
Enlightenment Capital	7
J.F. Lehman & Co.	7
Warburg Pincus	6
KKR	6
Liberty Hall Capital Partners	6
Audax Group	5
Platinum Equity	5
Tinicum	5
Odyssey Investment Partners	5
Top Strategic Buyers	
Heico	14
Mercury Systems	8
L3 Technologies	8
Ametek	7
General Dynamics	7
Transdigm Group Inc.	6
Boeing	5
Other*	4

***CAE, Cubic, Elbit Systems, Hexcel, Qinetiq, Accenture, BAE Systems, ParkOhio, FLIR, TT Electronics, Astronics, Saab.**

Source: Janes Capital Partners and Robinson+Cole

After an unprecedented pause in March-May due to COVID-19's breakout, deal-makers report a return to record activity and eye even more opportunities, especially if Democrat Joe Biden wins the White House and pursues certain tax increases, spurring a stampede to get in before they take effect.

"We've probably never seen such an abundance of deals," says Craig Chason, leader of law firm Pillsbury's Northern Virginia Office Corporate practice.

"The floodgates really opened in September," agrees Jean Stack, managing director in Baird's Global Investment Banking group and co-head of its government and defense practice.

Pillsbury hosted a webinar series on M&A in aerospace in October where Chason, Stack and other deal-makers talked about how "weird" 2020 has been, with a near-freezing of activity in the spring followed by today's rush. But even as PE investors held off at the time—to deal with the pandemic crisis within their own portfolio companies—strategic buyers still were hunting for targets, they say. Both sponsors and strategics are positioning for 2-3 years out, and the current Goldilocks atmosphere both reaffirms the sector's resilience while also providing a unique opportunity.

Looking ahead, many deal-makers see activity reaching new heights. "I expect the next 12 months to be an extremely busy time for this sector," says Bob Kipps, founder of KippsDeSanto & Co., an A&D and government services advisory firm.

Stack says the transformation within the sectors will be "awe-inspiring," including divestitures and new owner entrants. "Nothing is off the table," she says.