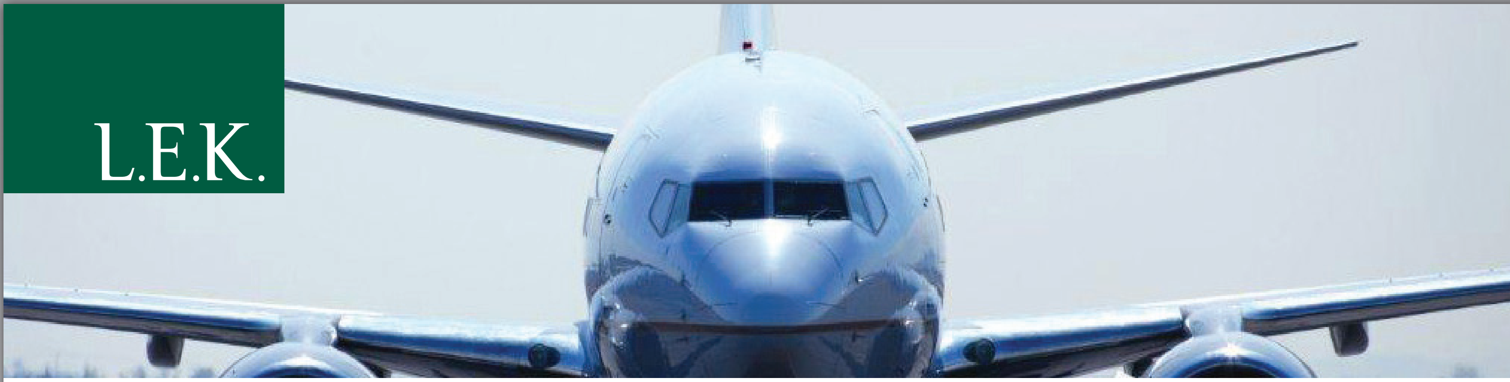

L.E.K.

EXECUTIVE INSIGHTS

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Pushing the Envelope: How PE Firms Can Capture Value in a Booming Aerospace Market

The global aerospace industry is at a highly promising point in its history, as rising demand for commercial and corporate jet aircraft around the world is creating a boom-time environment for the primes such as Boeing and Airbus, and is driving growth opportunities for the longer tail of systems, components and materials suppliers across the value chain. And with deal activity in the sector rebounding to pre-recession levels, there is ample opportunity for private equity (PE) firms to make aerospace investments and benefit from these favorable market characteristics.

However, they face two major challenges to doing so:

1. Building winning investment strategies in a consolidating market, and

2. Competing for deals against industry players who are becoming more acquisitive and much more aggressive with their bids.

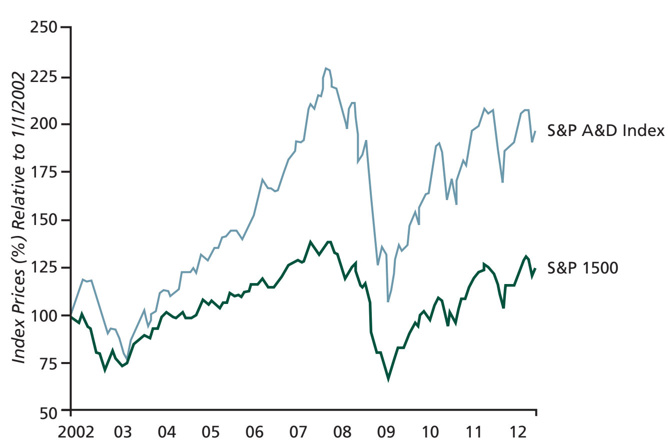
Despite these challenges, L.E.K. Consulting is convinced that there are great opportunities for PE firms in the aerospace sector, and this article outlines a number of key issues for those looking to make successful investments during this promising, but highly competitive period.

High Ceiling for Growth

The recent boom times for Boeing and Airbus are well documented, as they are seeing record order books and are forecasting double-digit production growth for the foreseeable future[1]. But while the two commercial aircraft giants capture the bulk of media attention, much of the aerospace value chain is benefitting from similar dynamics and features an equally strong outlook. Evidence of the broader industry's success can be seen in the S&P 1500 Aerospace & Defense Index, where over the past decade this composite of 29 original equipment manufacturer (OEM) and supplier stocks outperformed the broader S&P 1500 by nearly a four-to-one margin[2] (see Figure 1).

Figure 1

Aerospace & Defense Versus Broader Market Stock Performance (January 1, 2002 – June 30, 2012)



Source: S&P Capital IQ, L.E.K. analysis

[1] Boeing, Airbus, L.E.K. analysis
[2] S&P Capital IQ

Pushing the Envelope: How PE Firms Can Capture Value in a Booming Aerospace Market was written by **Darren Perry**, a Vice President of L.E.K. Consulting. Please contact L.E.K. at aerospacedefense@lek.com for additional information.

And based on our work across the global aviation landscape (and our position as the leading strategic advisor to the airline industry), L.E.K. believes that the aerospace sector is poised for continued success primarily due to the following:

- **The commercial aircraft market will continue to benefit from a variety of factors:**
  - An expanding global middle class with new disposable income for air travel
  - An increase in airline market liberalization, opening up competition on routes formerly controlled by national flag carriers
  - Airline demand for next-generation aircraft as a way to serve new markets and reduce operating costs
- **Market dynamics have business jets positioned for recovery and growth:**
  - Overall economic improvement and diminished public scrutiny of corporate jet travel in the U.S.
  - Reduced reliance on the U.S., as emerging international markets are finally expected to rival the U.S. for share of an estimated 10,000 business jet deliveries during the next decade[3]

Competitive Deal Environment

While these demand drivers paint a positive outlook for the aerospace industry as a whole, individual firms and investors face a rapidly changing and challenging competitive landscape. As the primes seek to lower input costs they are influencing a shift in the global supply base and supporting the emergence of new aerospace manufacturing clusters in Asia, Latin America and Eastern Europe.

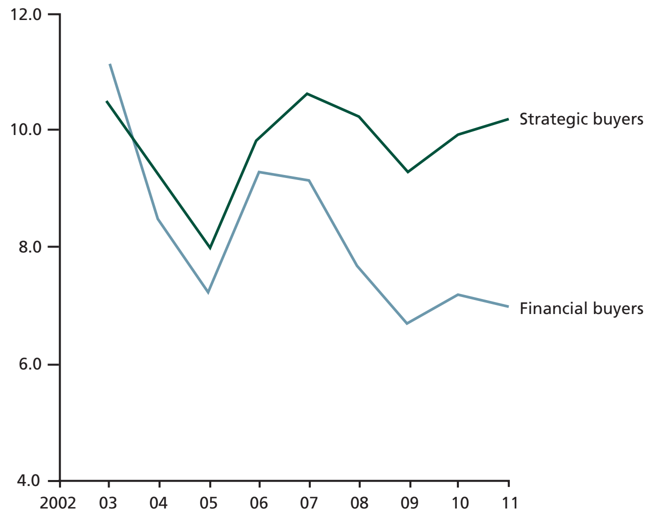
At the same time, there is a growing consolidation trend across the sector. At one end, Tier 1 integrators are on the acquisition path to broaden their system capabilities and maintain relevance for the primes (e.g., UTC-Goodrich). While at the other end, Tier 4 material suppliers are integrating vertically by acquiring or merging with Tier 3 component manufacturers to differentiate themselves and capture a greater share of the value chain (e.g., ATI-Ladish).

This combination of attractive demand factors and a consolidating industry has led to significant competition for PE firms looking for aerospace deals. Industry players have been very active with mergers and acquisitions (M&A) and have generally been willing to place higher values on assets that can improve their strategic positioning. In fact, during the last five years, transaction multiples for strategic and financial buyers have steadily drifted apart to the point where the industry players are currently paying nearly 50% more for aerospace & defense assets than their PE counterparts[4] (see Figure 2).

Figure 2

Aerospace and Defense Transaction Multiples by Buyer Type (2002-11)

24-Month Rolling Average Transaction Value/EBITDA
Deals Greater than $50M Transaction Value

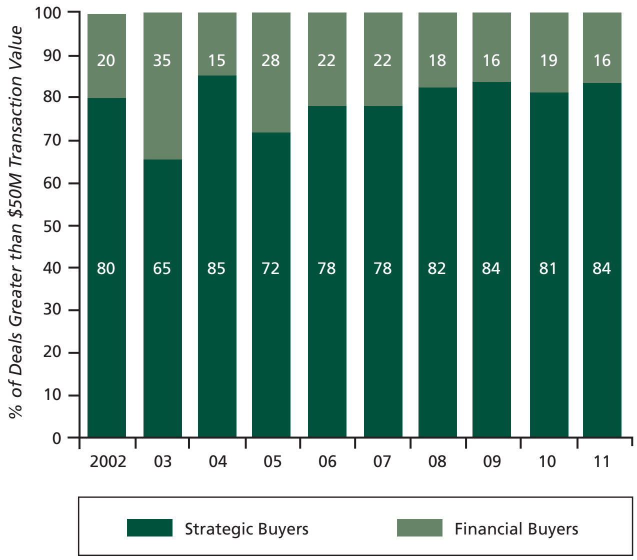


Source: S&P Capital IQ, L.E.K. analysis

[3] Honeywell - Business Aviation Outlook
[4] S&P Capital IQ
[5] S&P Capital IQ

Figure 3

Share of Aerospace and Defense Deals by Buyer Type (2002-11)



Source: S&P Capital IQ, L.E.K. analysis

Not surprisingly, strategic buyers have been able to increase their share of deals won versus financial buyers and now capture about five of every six transactions in the space[5] (see Figure 3).

Outmaneuvering the Competition

So what do industry consolidation and strong deal competition mean if you are a PE firm looking to invest in aerospace? L.E.K. believes there are two imperatives for PE in light of these dynamics:

1. Move beyond thinking about discrete aerospace targets and consider sub-sector roll-up strategies to build a winning market position in the face of a consolidating industry, and

2. Develop a plan to enhance – *perhaps even change* – your aerospace targets' business models in order to compete with aggressive bids from industry players.

Sub-sector Strategies

To create value in aerospace, PE firms will need to have a plan for how their assets can thrive in the rapidly changing environment – which means identifying where and how they can develop an advantaged position as the value chain consolidates across all levels. For example, as the M&A game plays out, if a PE portfolio company (or collection of companies) ends up being the only player capable of making a key component out of a particular material, or to a particular spec, it becomes a truly valuable asset to own. But to achieve that, PE firms will likely need to move beyond targeting companies individually and instead embrace roll-up strategies to protect share and reach critical scale in a key input or capability.

To this end, PE firms will need to look to where the aerospace industry is moving, identify the key inputs or capabilities that have not already consolidated, and then run roll-up strategies to build these firms into powerful niche players that can compete and thrive in the market. Furthermore, it will be important to do so quickly. Wait too long and the attractive assets will likely have already consolidated, leaving fewer options and higher asking prices.

Enhancing the Business Model

While evidence of solid market fundamentals, a differentiated competitive position and a strong management team may be enough to support strong bids in other industries, competition for aerospace deals will increasingly require PE firms to identify and validate upside potential as well. Although this may sound challenging to some, it actually creates a great opportunity for those firms seeking a competitive edge. The PE firms that can draw on the best industry knowledge and strategic capabilities will have the insight and confidence to act most aggressively in the auction process.

During its nearly three-decade history of working with and evaluating aerospace assets, L.E.K. has uncovered hidden value in a variety of areas. And while no two deals are the same, upside opportunities for PE firms to consider may include:

- **Value pricing:**
  - Given the increased supplier power that comes with industry consolidation, pricing optimization can be a powerful (and often underutilized) value driver
  - Accurate customer segmentation and a proper analysis of margin data can often identify sub-optimal pricing practices and uncover meaningful upside potential

- **New market entry:**
  - As a significant portion of future demand will come from new international markets, firms will need a keen understanding of aviation customer needs in their targeted regions
  - Firms that can tailor their approach to meet these needs (e.g., product/performance, cost characteristics, sales channel, etc.) have an opportunity to capture early-mover benefits in the fastest growing markets

- **Product innovation:**
  - In an industry that is often overly engineering-driven, understanding customers' needs (and often *their* customers' needs), and applying an outside-in approach to product development can drive outsized benefits
  - Fact-based customer segmentation, detailed field research, and proven analytical techniques such as conjoint analysis can uncover valuable product or feature gaps in the market

- **New business models:**
  - In certain instances, moving beyond the target firm's traditional business model may present the greatest potential for value creation (this includes going beyond just changing manufacturing location)
  - For instance, "non-core" assets being spun out of larger entities may find that they can play a broader – perhaps even a different – role for the industry when stripped away from their parent companies (software/data assets may be particularly interesting in this regard). The challenge for PE firms is to identify and validate these opportunities early in the process
  - Performing targeted customer research, coupled with a deep understanding of broader market dynamics, can serve to validate break-out strategies

When put into action, techniques such as these can enable PE firms to win attractive assets, and also maximize the eventual return they can achieve on their investments.

As an example, L.E.K. recently supported a PE firm in acquiring an aerospace component manufacturer, where vetting the asset's upsides and developing a new growth strategy played a key role in a successful outcome. In addition to performing the standard commercial diligence (market size and growth, customer satisfaction, competitive positioning, etc.), L.E.K. identified and vetted a number of promising upsides and developed a full growth strategy for the target, including new growth vectors for the most lucrative product segment and opportunities for pricing optimization.

Armed with this plan, the PE firm was able to put in an aggressive bid and won the asset. And after executing the strategy as the business owner for roughly three years, it ultimately sold the asset to a Tier 1 supplier – *for more than double the original purchase price.*

Flight Plan for Success

Given the strong global demand outlook for new aircraft, the aerospace sector should remain an attractive investment area for PE firms. While the dynamics of a consolidating industry and high transaction multiples create a challenging deal environment, firms prepared to push the envelope – through both sub-sector investment strategies and plans to enhance their targets' business models – stand to capture the greatest value in this booming market.

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and analytical rigor to help clients solve their most critical business problems. Founded nearly 30 years ago, L.E.K. employs more than 900 professionals in 20 offices across Europe, the Americas and Asia-Pacific. L.E.K. advises and supports global companies that are leaders in their industries – including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. L.E.K. helps business leaders consistently make better decisions, deliver improved business performance and create greater shareholder returns.

For further information contact:

Boston
75 State Street
19th Floor
Boston, MA 02109
Telephone: 617.951.9500
Facsimile: 617.951.9392

Chicago
One North Wacker Drive
39th Floor
Chicago, IL 60606
Telephone: 312.913.6400
Facsimile: 312.782.4583

Los Angeles
1100 Glendon Avenue
21st Floor
Los Angeles, CA 90024
Telephone: 310.209.9800
Facsimile: 310.209.9125

New York
1133 Sixth Avenue
29th Floor
New York, NY 10036
Telephone: 646.652.1900
Facsimile: 212.582.8505

San Francisco
100 Pine Street
Suite 2000
San Francisco, CA 94111
Telephone: 415.676.5500
Facsimile: 415.627.9071

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