2021: A Turning Point in A&D for Deal Makers

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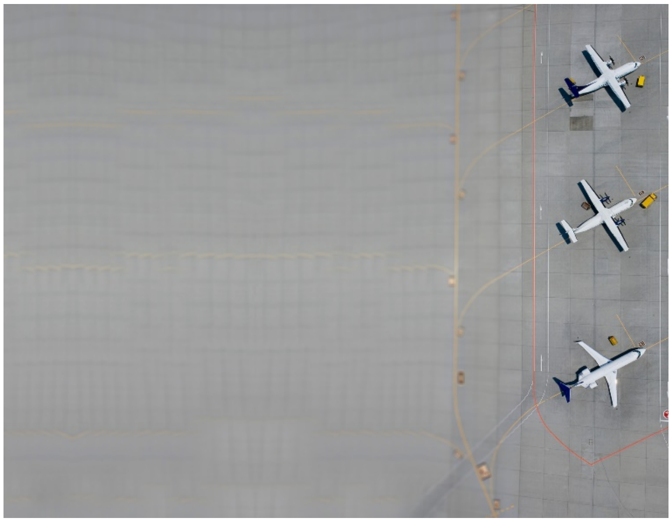
Three closely intertwined trends will shape M&A activity for the foreseeable future

The year 2021 is likely to prove a turning point in the global aerospace and defence (A&D) industry that will have significant implications for corporate dealmakers for several years to come.

In this column, I explore three closely intertwined trends – geopolitics, the recovery from the pandemic, and digital transformation – that will shape merger and acquisition (M&A) deal activity. The intersection of these trends, combined with the economic impact on the players, makes it imperative to undertake a review of M&A strategy.

First, continuing geopolitical tensions will stiffen governments' resolve to maintain defence spending.

As a result of global supply chain interruptions during the pandemic, governments and global A&D players alike took steps to strengthen policies that enhanced self-sufficiency, including domiciling production in their home country or only with partners in trusted nations.



Second, the pandemic-induced dislocation of the aviation sector is likely to spur restructuring and consolidation, especially in civilian aerospace, although that's also partly complicated by large-scale government interventions that make M&A deals more complex.

The emergency fiscal measures taken to mitigate the economic effects of COVID-19 have caused public debt to balloon, severely constraining government budgets for the foreseeable future. This limits their ability to further support the civilian aerospace industry, and if it results in cuts in defence programs, A&D contractors may be forced to diversify product and service offerings to reshape their portfolios and refocus on core capabilities and markets.

Insofar as Canadian suppliers are concerned, current U.S. budget proposals suggest defence spending to stay flat or decline only modestly. But, heightened competition for fewer defence programs and the possible re-emergence in the U.S. of lowest-price, technically acceptable contracts may well prompt consolidation, with both vertical and horizontal integration strategies.

Third, another key M&A driver is the growing need for digital transformation and innovation, especially around leading-edge capabilities in areas such as space, artificial intelligence, and unmanned vehicles. As we detail in our recently released *Future of M&A in Aerospace and Defence* report, countries increasingly recognize the need for an innovation overhaul.

The nature of warfare is shifting from counterinsurgency and terrorism to countering near-peer adversaries and modernizing defence infrastructure, driving investments in technology systems, analytics, cybersecurity, and communication networks. The defence industry must ensure its industrial base can deliver technological advantage and attract necessary talent, in addition to the continued need for capital.

Data – its capture and analysis – is at the heart of digital transformation. Governments may well impose stricter constraints on the owners and users of data, increasing compliance costs, due to concerns over privacy and the potential abuse of market power by a small number of companies. Indeed, in the past three years, many M&A deals in A&D occurred in government and IT services and software.

If U.S. OEMs, for example, invest domestically in critical technologies, such as micro-electrics and artificial intelligence, we are likely to see a continued focus on on-shoring of Tier 2 and 3 activities. Much of this investment will go into financial support for key suppliers, potentially leading to vertical integration.

The M&A landscape is changing, with OEMs divesting of non-core business units while acquiring innovative know-how through tuck-in deals, private equity players more focused on A&D opportunities and investment in the US by special purpose acquisition company (SPAC) mergers of next-gen technology providers that are positioned to take advantage of rapidly growing markets.

Near-Term Outlook

These three major trends may lead to a range of outcomes for A&D over the next two-to-three years, ranging from reshaped product portfolios and divestments to increased M&A and private equity involvement.

In Canada, with the federal deficit forecast at C$354.2 billion for 2020-21, primarily from pandemic-related emergency funding and stimulus programs, defence spending is expected to hold at current levels.

With several significant government defence procurement projects underway, foreign-owned multinationals continue to scope out the Canadian market for opportunities to invest in small- and medium-sized entities that offer a niche capability to enhance their ability to participate in these programs.

As the Canadian domestic market is not large and exports are critical for success, Canadian companies are also looking to expand their global footprint in both developed and emerging A&D markets.

Companies with feet in both military and civilian camps will be relying on their military business to help them through the next few lean years. Some will want to diversify further and acquire more defence-manufacturing assets to increase their exposure to the military market.

In today's new reality, A&D companies will need flexible valuation models, innovative deal structures, and analytical techniques to move quickly and decisively as the M&A market heats up. The time to act is now.

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