Aerospace & Defence insights

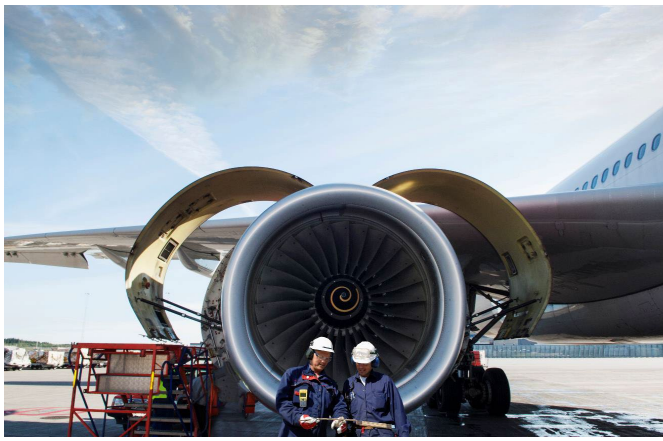
Getting fit for the new future

April 2020

The COVID-19 pandemic is unlike previous shocks that have impacted the A&D sector. At the outset, organisations have focused on immediate measures to keep their people safe and their businesses solvent. Those that have done this strategically and continue to do so will be in the strongest position – ensuring they are right-sized and 'fit for the new future', with operations capable of offsetting scale reductions with enhanced efficiency.

As an industry, reaching consensus on the 'new future' as quickly as possible is critical and will allow supply chains to adapt to revised production rates and collectively identify/mitigate transition risks.

Significant consolidation is expected and those organisations with strong balance sheets will be best positioned to take advantage of undervalued assets or bail out suppliers to safeguard supply chains.



What this paper considers

01 Comparisons to prior shocks and what this means for the industry

02 Activities that companies may be considering to be 'fit for the new future'

03 How the KPMG A&D team can use our sector experience combined with the breadth of KPMG's global capabilities to support the UK supply chain at this critical time

How does COVID-19 compare with prior shocks?

The COVID-19 shock differs from prior shocks to the A&D industry for many reasons. Early indications point to a far more serious impact than either 9/11 or the 2008/09 global financial crisis:

01 Air traffic is down significantly, with carriers announcing unprecedented capacity reductions (deeper than those following the 9/11 attacks). With months of continued lockdown expected globally it is estimated that the airline industry will see at least a 40% reduction in RPKs, setting airline revenues back to 2005 levels where fleets were approx. 30% smaller[a]. This is having an immediate impact on the MRO sector and spares sector where there is not the cushion of extended lead times and order backlogs.

02 The financial strength of the airlines is at an all time low with consolidation of the industry expected. This is going to exacerbate the pressure on the order backlog, with a number of cancellations already occurring.

03 Unlike previous shocks, low fuel prices as well as relatively young fleets are reducing the need to modernise fleets with more efficient aircraft – after 9/11 this helped create a surge in demand that we are unlikely to see this time.

04 A global financial recession, allied to post COVID-19 medical concerns, will place significant pressure on passenger yields and the hub and spoke model. Airlines will reconsider their fleet strategies with ramifications for wide body in particular.

05 After 9/11, we headed into the Global War on Terrorism and in 2008, NATO was deeply engaged in active combat. Neither is true today. At best, we can plan for stable defence budgets, but there is a possibility we may see defence funding diverted to non-defence areas. If this occurs, it would be an unprecedented double shock to the industry.

06 Should businesses successfully adopt the temporary work-from-home and limited travel policies, we may see a structural shift (although small) in near-term post-pandemic (and potentially longer-term) passenger demand, also leading to a longer recovery path relative to prior shocks.

Whilst opinions still vary from a V to L shaped recovery it is clear that there will be a 'new future' and how the UK supply chain responds to these potential scenarios will dictate the future success of the industry in the UK.

a) IATA analysis: https://www.iata.org/en/iata-repository/publications/economic-reports/covid-19-cash-burn-analysis/

What are applicable lessons from prior shocks?

While this COVID-19 shock is unique, lessons from prior shocks are relevant. The most important lesson is how companies that took rapid action fared much better compared with those companies that simply "hunkered down."

Companies that took rapid and decisive action

Companies that moved quickly – yet in a thoughtful and strategic manner – to take necessary actions and make needed cost reductions, rather than across-the-board reductions, fared better. These organisations reshaped and repositioned their businesses to fit the new reality. They right-sized operations and selectively divested assets. They sharply reduced overhead but maintained – and sometimes increased – investments for future work packages and programs.

Some also pursued acquisition opportunities, obtaining assets and capabilities at low multiples. As a result of these strategic actions, these companies emerged stronger and better positioned than they otherwise would have.

Companies that hunkered down

Some of these organisations delayed actions in this uncertain period in hopes of a fast recovery, and others took across-the-board cuts, without fundamentally reshaping their businesses, asset bases, overhead cost structures, or portfolios – all moves that could have positioned them to compete better in a new reality.

This set of companies fared much worse than the first group, and some ultimately became acquisition targets losing the ability to shape their destinies.

The current environment will shape how resilient A&D companies are when they emerge post COVID-19.

How could organisations ensure they are 'fit for the new future'?

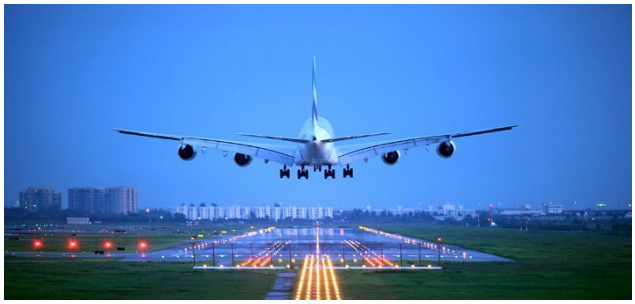
What could A&D leaders be doing next? Companies have already swung into action – assembling teams to manage employee safety and welfare, work-from-home arrangements, etc. Beyond these immediate steps there are a number of key actions required over the coming quarters and potentially longer term, which KPMG can support you through.

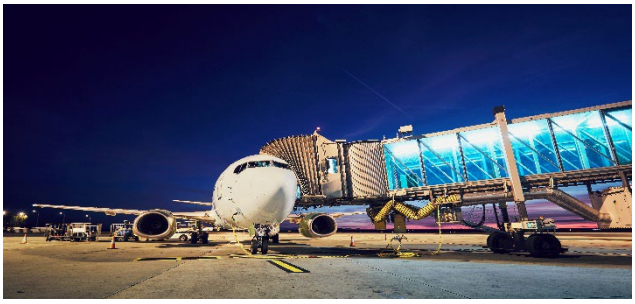
These include the following:

- **Challenge the existing business strategy** – organic and inorganic, make versus buy. What was right before may not be right for the future. Do you have the right data to support decision making?
- **Maximising the 'runway' for strategic reorganisation** through exploring all options for cash optimisation and seeking a financing structure (debt and/or equity) which will facilitate the return to growth of the business. The major strain on cash flows will occur post the cessation of government support and coinciding with the inevitable ramp up in working capital.
- **Not using a simple 'reduction in place' approach** to reducing headcount or other costs. Reshape activities, organisations, footprint, and businesses, as required, to right size to the new reality ensuring that vital engineering skills are retained and emerging talent is not lost.
- **Identifying supply base risks** – they are likely to increase as we exit this phase – with potential liquidity challenges at some suppliers or security concerns, as overseas competitors target key suppliers in the supply chain. Seek to mitigate these risks.
- **Scenario-based approach for business modelling** and forecasting – both in the short term and medium term. Factoring in timing and potential economic impacts, mapping scenarios to required mitigation actions.
- **Ensuring that the management information** in the business, including dynamic actual costing, **supports informed decision making** around cost optimisation and pricing of new and existing work packages.
- **Identify what is core and non-core** under the new strategy and where there are the potential gaps that can be filled through M&A.

How can KPMG support?

- **Stakeholder management** – Openness and transparency is key at this time in order to create the platform to restructure and execute the strategy. We act as retained board advisers where our experience allows boards to pre-empt and address stakeholder requirements and to provide independent challenge. We can also bring leadership together in our virtual innovation centre and support with 'War Gaming' scenarios.
- **Options review and execution** – Developing options available to support liquidity including equity injections, debt refinancing and accelerated M&A along with the ability to execute these options.
- **Recapitalisation and refinancing of debt/covenants** – Providing informed but independent perspectives on business plans – supporting debt and equity raises and ensuring scenario planning has explored all options.
- **Cash optimisation** – Support in understanding cash forecast profiles, potential sensitivities and the cash levers available to improve liquidity. Demonstrating governance and an appropriate approach to this is also key in gaining stakeholder confidence.
- **Supply chain consolidation and accelerated M&A** – Advising clients as buyers through an accelerated M&A process, thereby ensuring you are well positioned to benefit from supply chain consolidation.
- **Accurate and dynamic management information (MI)** – We work with businesses to provide cost effective means of delivering MI which will support effective decision making.
- **Non-core divestments** – Supporting clients to maximise value with a 'one stop shop' across M&A, financial preparation, tax and legal – leveraging our UK and global A&D network.





Collaborating with competitors, customers, suppliers and stakeholders, and applying a long term lens to ensure 'fit for the new future' is key…

	E1 1-2 weeks Entry	E2 You are here Existence	E3 Exit
OBJECTIVES	— Staff wellbeing — Optimise cash position — Rapidly access Government funding — Controlled mothballing of operations — Protect the business — Plan for existence phase	— Staff wellbeing and plan for return to work — Protect the business — Minimise cash burn — Consider working capital for exit — Reforecast business and stress test — Reshape the strategy, plan implementation — Consider access to funding for the restart	— Implement return to work plan — Optimise your working capital cycle and consider access to funding (through equity, debt of JV's/ collaborations — Restructure balance sheet and debts — Controlled ramp up of operations — Execute business reshaping and new/revised strategy
ACTIONS	1. Optimise cash reserves and rapidly access Government bailout funding 2. Consider staff welfare and remote working protocols 3. Open dialogue with customer and suppliers to evaluate key risks and update contingency plans 4. Enhance cybersecurity and privacy protocols 5. Contingency planning and crisis response	1. Minimise cash burn in the business and prepare to access working capital funding for exit phase 2. Maintain short term cash flow forecasts, reforecast business and stress test 3. Ongoing monitoring of scenarios and further requirements for activating cash and cost levers 4. Robustly challenge business strategy and reshape as necessary 5. Capture permanent positive impact of employee behavioural changes and enhance monitoring of IT infrastructure and incident response capability 6. Plan for the impact of possible supplier failure and regularly engage with both suppliers and customers in order to exit together	1. Robustly manage cash to optimise working capital as business grows 2. Regularly review forecasts – it is likely assumptions will need to be revisited 3. Implement new strategy and keep under review – markets will change and pre crisis norms may not be relevant 4. Develop and execute plan to move to medium/long term financing structure 5. Enhance supplier risk management protocols and develop new approach to credit control

> It is likely going to take strong, rapid and decisive actions to get costs realigned, in order to position cost structures, asset bases, supply bases and business portfolios to weather the storm and be well situated for the next cycle.

The Aerospace & Defence industry has experienced more than ten years of sustained health in both commercial and defence markets and therefore these actions may feel extreme. But remember, the A&D companies that most successfully navigated prior downturns were better positioned for the next cycle and delivered better shareholder returns through the recovery.

KPMG recognises that these are challenging times for us all and we are here for our clients and ready to help – be that simply answering questions, acting as a sounding board for ideas or rapidly deploying teams on an engagement, with the full force of our global network to support you. KPMG is committed to you, our clients.

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